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**Regional Financial Arrangements:
Lessons from the Eurozone for East Asian Regional Institutions and Infrastructure**

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Abstract:

Financial integration in East Asia has been building steadily over the past two decades. In order to support this process, officials in the region have undertaken a range of initiatives. These include, in particular, the Chiang Mai Initiative Multilateralisation (CMIM), the Executives' Meeting of East Asia Pacific Central Banks (EMEAP), regional initiatives of international organizations such as the Bank for International Settlements (BIS) and Financial Stability Board (FSB), and aspects of ASEAN, the ASEAN Economic Community (AEC) and ASEAN+3. Prior to the global financial crisis (GFC) and the Eurozone debt crisis, the European Union had served as a model for East Asian financial integration. The lessons learnt by the failure of EU institutions to deal first with the consequences of the GFC and subsequently with the Eurozone debt crisis are also useful and, in part, relevant to the East Asian financial integration process. This paper reviews the causes of the Eurozone financial crisis and draws parallels with the weak institutional infrastructures underpinning East Asian financial arrangements. The paper focuses on two areas of great concern: (a) crisis prevention and (b) crisis resolution. In particular, it highlights the challenges raised by integrated supra-national banking markets in the absence of suitable institutions to absorb financial stability shocks. Based on this discussion the paper will present suggestions for future development of East Asian regional financial arrangements as they relate to crisis prevention and resolution. Finally, the paper links the financial stability debate with the more general issues of financial liberalization and free movement of capital, trade in financial services, and freedom of establishment in the context of the AEC and ASEAN+3.

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I. Introduction

In the aftermath of the Asian financial crisis, two sets of policies (and approaches to economic development) battled for supremacy: (a) protectionism, which conditions economic development on closed markets and (b) liberalization and regional market integration. This was a battle that was soon lost by the supporters of protectionism. In the 2000s liberalization and market integration came to be regarded as the only sustainable path to the region's continuous economic prosperity. East Asian countries have expended a great deal of effort on the development of regional financial arrangements to support regional financial integration and stability.¹ These include, in particular, the Chiang Mai Initiative Multilateralisation (CMIM), the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) and aspects of the Association of South East Asian Nations (ASEAN), the ASEAN Economic Community (AEC) and ASEAN+3.² Prior to the global financial crisis and the Eurozone financial crisis, the European Union was often portrayed as a positive model for East Asian regional institutional arrangements.

The 2008 Global Financial Crisis spread to most of the developed economies, including those of the European Union. Irrespective of the nature and extent of banking and securities regulation harmonization and form of regulatory structures (be it unitary in the United Kingdom, twin-peaks in the Netherlands, or sectoral at the regional level) almost all EU jurisdictions lacked proper crisis resolution mechanisms, especially with respect to the inevitable strong cross-border dimensions of a global crisis.³ This led to a threat of widespread bank failures in EU countries and near collapse of their financial systems. The GFC bore striking similarities but also considerable differences with the Asian Financial Crisis of the late 1990s. Today, in the midst of the Eurozone financial crisis, the EU is at a critical crossroads. It has to decide whether the road to recovery runs through closer integration of financial policies and of bank supervision and resolution, or is subject to a gradual return to controlled forms of protectionism in the pursuit of narrow national interest, although the latter is bound to endanger the single market. Therefore, the policy dilemmas facing the EU and contemporary institution building within the Eurozone

¹ See Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area, signed at Cha-am, 2

³ See E. Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (CUP, 2012), ch. 6. See also Recine, F., & Teixeira, P. G. (November 2009). The New Financial Stability Architecture in the EU (November 2009). *Paolo Baffi Centre Research Paper No. 2009-62. Available at SSRN: <http://ssrn.com/abstract=1509304> or <http://dx.doi.org/10.2139/ssrn.1509304>.*

can provide a range of useful lessons for the future development of regional financial arrangements. It is in this context that this paper discusses the lessons the Eurozone crisis holds for East Asian regional financial arrangements, specifically focusing on crisis prevention and crisis resolution mechanisms. Based on a review of the Eurozone / EU experience to date, the paper considers the future development of East Asian regional financial arrangements, focusing on CMIM, EMEAP and ASEAN/+3, especially as they relate to crisis prevention and resolution. Finally, the paper looks forward to possible lessons for future financial liberalization initiatives in the context of ASEAN/+3 and related objectives of free movement of capital, trade in financial services trade, and free establishment.

A central idea of this paper is that the design of institutions underpinning regional integration has to be a step-by-step process. From CMI to CMIM and from ASEAN to ASEAN+3 and AEC, East Asian arrangements follow a pattern of development of institutions that presents striking similarities with that followed by the EU, albeit over many previous decades, starting with the European Coal and Steel Community and the European Economic Community (EEC)⁴ and from there to the EU and ultimately to the European Economic and Monetary Union (EMU) and the introduction of the single currency.⁵ Arguably, problems will inevitably arise when a supra-national market exhibits a high degree of integration but the development of cross-border regulatory mechanisms lags significantly behind. This shortcoming has become acutely evident in the course of the current Eurozone crisis. In this context, we explain the European crisis as the result of four interlocking crises: a banking crisis, a competitiveness crisis, payment imbalances within the Eurozone indicating structural

⁴ The EU traces its origins in the European Coal and Steel Community (ECSC) and the European Economic Community (EEC). The ECSC was established in 1951; it was a six-nation international organization serving to abolish trade barriers in the areas covered by the Treaty between the democratic nations of Western Europe, as the Cold War had divided the geographic area covered by European nations in two via the so-called 'iron curtain'. The ECSC was the first purely European organization in the postwar era to be based on the principles of supra-nationalism. The Treaty of Rome established the EEC in 1957 on much broader objectives and principles of co-operation for the achievement of which it also introduced a number of permanent supra-national institutions, such as the Commission and the European Court of Justice (ECJ).

⁵ The Maastricht Treaty established the European Union (EU) in 1993. The same Treaty introduced the charter of the European Monetary Union. The EU Treaty has undergone a series of amendments as its ambit and reach, both in terms of new members in terms of powers, became ever broader. The latest amendment of the EU treaty is the Treaty of Lisbon, 2009.

asymmetries, and a sovereign debt crisis.⁶ This paper will analyse how similar mistakes are repeated in the Asian integration process where some aspects, for example, transactional integration have moved much faster than other pre-requisites of financial integration.

The paper is in five parts. Part I is the present introduction. Part II provides an analytical overview of economic and institutional developments relating to the EU single market for financial services in the pre-crisis period. Part III discusses the accepted causes of the Eurozone crisis and the way this evolved to become the most important threat to global financial stability today. Requisite discussion extends to the evolution of institutional infrastructure safeguarding financial stability and the effective supervision of financial institutions in the EU from its early stages. Part III reviews the main tenets of the European Banking Union and considers how this new set of EU institutions will affect EU's economic and political integration. Part IV provides an analytical overview of the East Asian regional financial arrangements and offers a critical evaluation of such arrangements and of their potential vulnerabilities. Part V concludes with a proposal that may be of critical importance to the future of financial integration in East Asia.

II. Development of the EU Single Financial Market

A. Challenges of European Financial Integration

The European experience constitutes the most advanced global laboratory for regional economic, legal, and political integration.⁷ Thus, it is worth examining the process of regional financial integration, as it developed in Europe, in order to discern inherent and artificial obstacles to efficient financial governance regimes for an integrated market. The establishment of pan-European banks has, of course, been the most potent integrative factor, in an environment marked, at least at the earlier stages, by absence of regulatory cohesion. At the same time, it was inevitable that the concurrent presence of pan-European banks and of incoherent regulatory structures would lead to financial instability across the single market and especially across the single currency area, in the event of serious market turbulence.

⁶ Presentation by Avgouleas, E. (July 2012). *Eurozone Crisis and Sovereign Debt restructuring: Intellectual Fallacies and New Lines of Research*, given to the Society of International Economic Law (SIEL), 3rd Biennial Global Conference, National University of Singapore.

⁷ Wouters, J., & Ramopoulos, T. (2012). The G20 and Global Economic Governance: Lessons from Multilevel European Governance? *Journal of International Economic Law*. doi: 10.1093/jiel/jgs036

The establishment of a single currency area (the Eurozone) and the pan-European presence of a number of large banks with large cross-border operations lent urgency to questions about long-term protection of EU-wide financial stability in the absence of appropriate institutional arrangements.⁸ The so-called financial stability trilemma,⁹ which states that the (three) objectives of financial stability, financial integration, and national financial policies cannot be combined at the same time, has precisely described the acute policy tradeoff which holds that one of these objectives has to give in to safeguard the other two.¹⁰ In spite of assertions to the contrary,¹¹ the recent crisis has proven beyond doubt that a common currency area is not viable without building, at the same time, transnational supervisory structures in the field of fiscal monitoring and responsibility and bank supervision.

Arguably, an essential pre-requisite of financial market integration is importation of a harmonized set of core rules, which border on uniformity¹² and are binding in all jurisdictions comprising the single market. Absence of such uniformity can, in theory, seriously hinder market integration as it can give rise to regulatory arbitrage and hidden protectionism and harm efficient

⁸ In 2005 Schoenmaker and Oosterloow conducted a statistical study spanning a four-year period (2000-03) on the potential emergence of pan-European banking groups. To this effect they gathered a new data set on cross-border penetration (as a proxy for cross-border externalities) of 30 large EU banking groups. They found a home country bias, but the data indicated that the number of groups having potential to pose significant cross-border externalities within the EU context was not only substantial but also increasing. Policymakers therefore had to face the challenge of designing European structures for financial supervision and stability to deal effectively with these emerging European banking groups. See for details, Schoenmaker, D., & Oosterloow, S. (2005). Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities. *International Finance*, 8(1), 1–27.

⁹ See, Schoenmaker, D. (February, 2011). The Financial Trilemma. *Duisenberg School of Finance Amsterdam & Finance Department VU University Amsterdam; Tinbergen Institute Discussion Paper; Forthcoming in Economics Letters*, 7. See also, Thygesen, N. (2003). Comments on The Political Economy of Financial Harmonisation in Europe. In J. Kremer, D. Schoenmaker & P. Wierds (Eds.), *Financial Supervision in Europe*: Cheltenham: Edward Elgar.

¹⁰ C.f. Lastra and Louis who (perhaps more accurately) describe the same trade off as an ‘inconsistent quartet’ of policy objectives: free trade, full capital mobility, pegged (or fixed) exchange rates and independent national monetary policies (Lastra, R. M., & Louis, J.-V. (2013). *European Economic and Monetary Union: History, Trends, and Prospects*. Yearbook of European Law.

¹¹ See Tommaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the Kings and the Genies* (Oxford: Oxford University Press, 2000).

¹² Uniformity in this context only means the need to have coherence and compatible rules and regulations across jurisdictions.

group approaches to capital allocation and risk management within cross-border banks.¹³ There is no area where divergence of national rules and regulations is more important than cross-border bank failures. Thus, protection of financial stability in an integrated financial market characterized by cross-border financial institutions becomes a very challenging task, especially when there are incongruent policy measures between national preferences and regional integration requirements. While, at the later stages of single market development the EU has moved very close to maximum harmonization in the field financial market regulation, the overall European regulatory edifice lacked strong uniformity/consistency both in terms of rule construction and rule enforcement in this area. In addition, there has been a marked absence of institutions that could provide binding guidance, in the event of difference of opinion between national regulators, as regards the application and enforcement of financial regulation, or could resolve eventual conflicts of national regulatory actions.

The complexity of the financial integration process and its significance means that it is impossible to understand contemporary developments within the Eurozone without a discussion of the different forms of integration and of the history of financial integration in Europe. In the following paragraphs we provide a conceptual categorization of the different forms of integration and an historical account of the EU financial integration process.

1. Different forms of integration

It is important to draw a distinction between economic, monetary and political forms of integration before looking at the specific properties of EU financial integration. Economic integration normally refers to integration of national commercial and economic policies and elimination of trade barriers and of obstacles to foreign direct investment (FDI).¹⁴ Monetary integration¹⁵ refers to formal currency alignments and interest rate cooperation between states.

¹³ Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. Brussels: European Union.

¹⁴ For Ropke, the free and reciprocal flow of trade between the various national economies' is what defines economic integration. See, Ropke, W. (1950).

¹⁵ Monetary arrangements that supplement trade relationships have existed for centuries. In the Eastern Roman Empire, for example, the solidus coin—a currency whose metallic content was stable—circulated widely for more than seven hundred years. Its predecessor the denarius was undermined by emperor Diocletian's (284-305AD) debasing of the metal content of the coin to cover the penury of the Roman treasury at the time due to continuous defensive wars. This type of monetary arrangement was not a true

On the other hand, financial sector integration refers to the elimination of restrictions to cross-border capital flows that may involve transactions concerning loans, debt and equity securities, and of barriers to cross-border market access by financial intermediaries, as well as to rights of foreign firm establishment. The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics deal with a single set of rules, when they decide to transact in financial instruments and / or provide financial services, and firms and consumers have non-discriminatory access to such financial instruments and / or services. It must also provide non-discriminatory regulatory oversight arrangements.¹⁶ Finally, political integration is equally important. It involves the voluntary sharing/pooling of sovereignty, whether in commercial and financial affairs, trade-policy cooperation/co-ordination, or in relation to justice and national security.¹⁷ Thus, lack of political integration can hinder the flow of benefits emanating from monetary and financial integration.

2. Early Stages of European Financial Integration

Financial integration in Europe is a much earlier than late 20th century phenomenon, at least for the leading European markets. There is convincing evidence, which shows that by the mid-eighteenth century European equity markets were well integrated.¹⁸ Professor Neal, who explored the operation of the international capital market and links between Amsterdam and London in the early eighteenth century, has concluded that both markets were well integrated in the pre-World War I period (1870s to 1913). This was, in general, a period characterized by a

monetary union but rather a common-currency-standard area, because each country's monetary policy was separately rooted in a commodity—such as gold or silver—and they did not involve establishment of a common monetary authority or currency. Thus, they can hardly compare with the EMU. See, Meade, E. E. (March 21, 2009). Monetary Integration. *Rethinking Finance: Harvard International Review*. <http://hir.harvard.edu/rethinking-finance/monetary-integration>

¹⁶ See, Baele, L., Ferrando, A., Hördahl, P., Krylova, E., & Monnet, C. (April 2004). Measuring Financial Integration in the Euro Area. *Occasional Paper Series No. 14: European Central Bank*. P.7

¹⁷ On the main tenets of political integration in an intergovernmentalist rational bargaining framework see A. Moravcsik, "Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach," *Journal of Common Market Studies*, 34 (1993), 473-524.

¹⁸ Neal, L. (1985). Integration of international capital markets: quantitative evidence from the eighteenth to twentieth centuries. *Journal of Economic History*, 45, 219-226. Also, Neal, L. (1990). *The rise of financial capitalism: international capital markets in the age of reason*. New York: Cambridge University Press. Neal, L. (1992). The disintegration and re-integration of international capital markets in the 19th century. *Business and Economic History*, 2, 84-96.

transition from autarky to integrated world capital markets, and, thus, for many it constitutes the era of the first globalization. The term ‘financial integration’ however, was not used in this sense before the mid-1950s. German neoliberals during the 1950s advocated international integration through removal of trade barriers and the introduction of free convertibility. Machlup associated financial integration with capital mobility.¹⁹ Ropke stated that multilateral trade and free convertibility was only ‘a different expression’ for international integration just as bilateralism and capital controls are another name for international disintegration of the economy. As this argument goes, the greater the degree of regional integration by multilateralism and convertibility, the larger are the advantages of economic cooperation.²⁰ Yet evidence of the existence of a direct causal relationship between financial integration and economic growth remains inconclusive,²¹ as any economic growth benefits deriving from financial integration depend upon a number of preconditions necessary to facilitate the integration process.²²

When the six-state European Economic Community (EEC) was established, in 1957 (by the Treaty of Rome), furthering member states’ growth was the apparent but not sole objective of the founders. Political integration was a stronger long-term objective. Namely, building a single market was seen as an essential pre-requisite to political integration and not a self-standing goal. The fact that political integration in the EU is still nowhere close to what was envisaged by the founding fathers can easily explain the lack of adequate institutions supervising the single financial market and securing financial stability. For example, even one of the EU fundamental freedoms, the free movement of capital, became effective only after the signing of the Maastricht Treaty in 1992, a full 35 years after the Treaty of Rome, as it was essential in building a European monetary union and national restrictions in the free flow of capital could no longer be retained.

¹⁹ See, Machlup, F. (1977). *A History of Thought on Economic Integration*. New York: Columbia University Press.

²⁰ Ropke, W. (1950). *The social crisis of our time*. London: Hodge. See also, Dorn, J. A., & Xi, W. (Eds.). (1990). *Economic reform in China: problems and prospects*. Chicago: University of Chicago Press. P.120

²¹ Liu, Q., Lejot, P., & Arner, D. A. (2013). Forthcoming (ch 12, page.513)

²² Such integration pre-requisites include domestic institutional reforms, the maintenance of adequate and enforceable property rights, and adequate controls on money supply. See also, Dorn, J. A., & Xi, W. (Eds.). (1990). *Economic reform in China: problems and prospects*. Chicago: University of Chicago Press. P.121

B. The Role of the EU Treaties: An Ever Closer Union?

1. The path towards economic integration and the monetary union

The European economic integration process and the establishment of the Euro as the common currency of (as of today) seventeen EU member states has been incremental with periods of strong progress and of painfully slow growth. In general, it has been the product of political expediencies as much as of economic efficiency rationales and it has witnessed major crises and setbacks.²³

Western European economies and Japan have shown in the post-war era a marked preference for exchange rate stability. When the first set of European arrangements aiming at exchange rate stability failed, following the collapse of the requisite Bretton Woods arrangements, and the post-war world entered the era of floating exchange rates, EEC members created the European Monetary System (EMS) in 1979,²⁴ in order to manage and control currency fluctuations among EMS members. EMS was viewed as the first step towards permanent exchange rate alignment and paved the way towards the establishment of European Economic and Monetary Union (EMU). Eventually, EMU member states irrevocably pegged the exchange rates of member country currencies, which were replaced by single European currency.

At this point it should be noted that the establishment of the single currency was itself a matter of politics as much as of economic necessity. Of course, through a currency union, EU members could answer the classic monetary trilemma, which is built on the Mundell-Fleming model of an open economy under capital mobility.²⁵ The monetary trilemma famously states that a fixed exchange rate, capital mobility, and national monetary policy cannot be achieved at the

²³ See P Pierson, "The Path to European Integration: A Historical Institutional Analysis," *Comparative Political Studies*, 29 (1996), 123-63 and J. Story and I. Walter, *Political Economy of Financial Integration in Europe: The Battle of the Systems* (Manchester University Press, 1997).

²⁴ See, Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters (1978) Bulletin of the European Communities. December, No 12, pp 9–13. Regulations Nos 380 and 381/78, 18 December 1978, OJEC, No L379, 30 December 1978 (and their modifications); Agreement of 13 March 1979 between the central banks of the Member States of the European Economic Community laid down the operating procedures for the European Monetary System. Available at http://ec.europa.eu/economy_finance/emu_history/documentation/compendia/a791231en1771979compendiumcm_a.pdf See for analysis, Giavazzi, F., & Giovannini, A. (1989). See also, Marcello De Cecco, A. G. (Ed.). (1989).

²⁵ See, Mundell, R. A. (1963). Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates. *Canadian Journal of Economics*, 29, 475-485 available at <http://jrxxy.zjgsu.edu.cn/jrxxy/jssc/2904.pdf>

same time; one policy objective has to give. Therefore, under capital mobility and national monetary policy, fixed exchange rates will invariably break down.²⁶ However, as the EU has been very far from being an optimal currency area under the Mundell model,²⁷ and there was no fiscal integration or debt mutualization it was only a matter of time before the first strains would appear. It is, thus, arguable that the founders of the EMU just hoped that a single currency would pave the way for a fiscal and political union, something that has not yet happened. Moreover the desire for a political union might not have been the whole story.

From a political economy viewpoint European financial and monetary integration was not just an inter-governmental goal, or merely dictated by the conditions of increasing market integration and capital mobility in the EU. The interests of professional intermediaries may have also been a strong force behind the push for further integration. For example, the Eurobond and the Eurocurrency interbank markets were the markets that emerged as a result of national, legal and regulatory impediments to capital flows.²⁸ Given an excess supply of petro-dollars in offshore markets, their scale began to rival national markets in banking and securities. This led to protracted negotiations in the early 1990s between industry representatives and regulators that brought off-shore activity back into national markets, while subsuming the many disparate local practices. In fact, the early Eurobond market might have played the role of an imperfect substitute to financial integration, given that capital mobility was only a secondary EU goal until the 1990s.²⁹ Conversely, The 1966 Segré report was both very cognizant of the growth potential

²⁶ See, Obstfeld, M., Shambaugh, J. C., & Taylor, A. M. (2005). The Trilemma in History: Tradeoffs among Exchange Rates, Monetary Policies, and Capital Mobility. *Review of Economics and Statistics*, 87, 423-438.

²⁷ Mundell, R. A. (1961). A Theory of Optimum Currency Areas. *American Economic Review* 51 (4): 657-665

²⁸ See European Commission, *The EU economy: 2003 review* (Brussels: Directorate-General for Economic and Financial Affairs, European Commission, (2003) No. 6 at 320, <http://ec.europa.eu/economy_finance/publications/publication7694_en.pdf>.

²⁹ Robert Genillard, "The Eurobond Market" (1967) 23:2 Financial Analysts J. 144. The article concludes that the Eurobond market was a "fine example of the benefits of international collaboration by bankers in a fully competitive climate." See also Kurt Richebacher, "The Problems and Prospects of Integrating European Capital Markets" (1969) 1:3 J. Money, Credit & Banking 337.

attached to financial integration and of the potential for this objective to be confounded by commercial interests.³⁰

2. EMU membership criteria and realities

The path to monetary integration that was adopted by the Maastricht Treaty was based on a three-stage process and the fulfilment of convergence criteria. Only countries, which met the appropriate criteria, could gain Eurozone membership. The transitional framework under the treaty provided some flexibility in terms of the time required for the weaker candidate economies to converge with the strongest, especially as regards their macroeconomic outlooks and policies. However, such convergence proved in many cases no more than drawing board plans.

The Maastricht Treaty's convergence criteria included two basic conditions for euro membership: firstly, a three percent limit on general government annual deficit and a sixty percent limit on general government gross debt limit.³¹ It also included three other important criteria, which were inflation, long-term interest rates, and exchange rate fluctuations. Inflation was to be kept within 1.5 percent margin over that of any of the three EU countries having the lowest inflation rate. Long-term interest rates were to stay within a 2 percent margin over that of the three states with the lowest borrowing rates in the European Union.

As regards, exchange-rate fluctuations, there was a requirement of participation for two years in the Exchange Rate Mechanism II (ERM II), which provided for a narrow band of exchange-rate fluctuations. The reality was, however, in glaring contrast with the spirit of the Treaty, due to political pressures and the actual condition of the European economies, which even in the 1990s were mildly to grossly indebted states with considerable budget deficits. The Treaty itself had exceptions to provide political leverage in extending membership to certain countries while restricting it to others.³² Italy, the third largest economy in continental Europe

³⁰ See Claude Segré *et al.*, *The Development of a European Capital Market: Report of a Group of Experts appointed by the EEC Commission* (Brussels: European Economic Community, 1966). Segré argued for harmonization of non-retail national markets in ways later encouraged by the Eurobond market.

³¹ See article 104c of *The Maastricht Treaty on European Union and the Treaties Establishing the European Communities Protocols*. (February 07, 1992). Maastricht: Retrieved from <http://www.eurotreaties.com/maastrichtprotocols.pdf>.

³² Article 104c of the Maastricht Treaty stated that countries could exceed the 3 percent deficit target if 'the ratio has declined substantially and continuously and reached a level that comes close to the reference value' or 'excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value'. Euro area countries could similarly exceed the 60 percent gross debt target provided that 'the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.' See,

was running general government gross debt in 1998 at 114.9 percent of GDP (as against 60 percent required by the Treaty), Belgium's gross government debt (home to the EU capital, Brussels) was at 117.4 percent of GDP, and formation of a euro block was implausible without having both of these countries in the Eurozone. This makes visible a huge difference in the conditions of the European economies upon joining the Eurozone. In practice, these differences meant a much lesser degree of economic integration than had been envisaged in the earlier Werner (1970) and Delors reports (1989) respectively.³³ Moreover, the difference in the macroeconomic 'initial conditions' of the founding member states made it politically difficult to enforce the strict fiscal criteria laid down for EMU membership.

C. EU harmonisation legislation 1985-2009: Market Impact, Gaps and Loopholes

1. Harmonisation principles

Completion of the legal and regulatory framework has always been regarded as an essential prerequisite in the EU financial integration process. The first step towards this direction was to develop a harmonized set of minimum regulatory standards based on consensus.³⁴ This seemed more aligned with the overall objective of achieving a single market without having to endure excessive concessions on idiosyncratic national policy designs and preferences, which might make the harmonisation process politically untenable.

The Delors Commission's 1985 White Paper³⁵ preceded the enactment of the first amendment to the Treaty of Rome in 30 years, the so-called 'Single European Act'.³⁶ The White Paper outlined the reforms required in the pre-existing EEC legal framework in order to build a

The Maastricht Treaty on European Union and the Treaties Establishing the European Communities Protocols. (February 07, 1992).

³³ Under the Delors' report, economic union and monetary union form two integral and equally important parts of a single whole and would therefore have to be implemented in parallel (Point 21 of the report) available at http://aei.pitt.edu/1007/1/monetary_delors.pdf However, the Delors' report adopted a comparatively less centralized approach economic policy than the Werner report.

³⁴ This has been defined by one of us as the first EU financial services consensus. See Avgouleas, E (2005). The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets. *Yearbook of European Law*, 2004, 321 -61.

³⁵ European Commission, *Completing the Internal Market: White Paper from the European Commission to the European Council*, (1985) Com(85) 310 final.

³⁶ Single European Act [1987] O.J. L 169/1.

truly single market in the EEC (as it then was) and pave the way to monetary integration.³⁷ The White Paper noted at the same time that: ‘the legislation adopted by the Council and the European Parliament is either too detailed, or insufficiently adapted to local conditions and experience; often in stark contrast to the original proposals.’³⁸ However, maximum harmonization proved impossible for many areas of activity in the single market and the European Commission adopted instead the principles of mutual recognition, minimum harmonisation, and home country control. The three principles were subsequently enshrined in harmonisation legislation in a number of areas, including financial services. The internal market was to be based on minimum harmonisation of national regulatory systems and mutual recognition³⁹ through which member states would recognise each other’s laws, regulations, and authorities.⁴⁰ Use of minimum regional requirements was intended to limit competitive deregulation by state actors and regulatory arbitrage by commercial parties.⁴¹ It was also a reflection of how political collaboration can encourage adoption of sound market principles and practices.⁴²

The EU framework for financial services provided minimum standards for the establishment and operation of banks and other financial intermediaries, conduct of public offers on a national and pan-European basis, and extended to accounting, company law, and regulation of institutional investors, in the form of collective investments schemes. It also provided access to the single market unfettered by national borders or restrictions on activity, the so-called single passport facility.⁴³ Essentially, the purpose of the passport facility was to allow intermediaries to

³⁷ The Delors’ report provided for the establishment of a new monetary institution that would be called a European System of Central Banks (ESCB) responsible to carry out monetary policy and the Community’s exchange rate policy vis-à-vis third currencies.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ B. Steil, *The European Equity Markets: The State of the Union and an Agenda for the Millennium* (Brookings Institution Press, 1996).

⁴¹ Arner, D. W., & Taylor, M. W. (2010). The Global Credit Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation? *University of New South Wales Law Journal*, 32, 488-513.

⁴² Arner, D. W., Lejot, P., & Wang, W. (2009). Assessing East Asian Financial Cooperation and Integration. *Singapore Yearbook of International Law, Vol. 12, pp. 1-42, 2009.*

⁴³ EU financial services directives addressed issues relating to regulation of banks and banking markets, investment services firms, collective investment schemes, life and non-life insurance, and pension funds. See, Cranston, R (ed.), *The Single Market and the Law of Banking* (Lloyds of London Press, 2nd

deliver products or services into any part of the internal market and promote cross-border competition.⁴⁴ As a result, the ‘passport directives’ in financial services defined the kind of financial intermediary to which they applied, its activities and the market segment, the conditions for initial and continuing authorizations, the division of regulatory responsibility between the home (domicile) state and the host state, and aspects of the regulatory treatment of non-EU member states.⁴⁵ Authorized financial intermediaries that came within the ambit of one of the ‘passport directives’ could, on the basis of the home country license, offer banking and investment services on a cross-border basis, without maintaining a permanent presence in the target market, or through a foreign branch.⁴⁶ The home state would generally be responsible for the licensing and supervision of financial intermediaries, for their foreign branches, and for the fitness and propriety of managers and major shareholders. The host state would be responsible for conduct within their jurisdiction or in the course of offering services cross-border to clients residing within their jurisdiction.

The Maastricht Treaty, which established the European Union as a successor to the EEC, provided an impetus for states to implement prior financial services directives and led to members other than Ireland and the United Kingdom adopting legislation that was often foreign to their traditional market practices. One important influence in the success of the harmonization mechanisms adopted at this stage of EU integration process was the role played by the rulings of the European Court of Justice (ECJ). Being part of the EU obligated its member states to adopt and implement EU legislation, as national governments could be held liable in damages for failing to comply with EU-level decisions.⁴⁷

2. The gradual shift to maximum harmonisation

ed., 1995); Ferrarini, G, 1998. *European Securities Markets: The Investment Services Directive and Beyond* (Kluwer Law, 1998).

⁴⁴ Ibid

⁴⁵ Ibid

⁴⁶ A good discussion of the ambit of the provisions for investment firms may be found in Moloney, N. (2008). *EC Securities Regulation* (Oxford, 2nd edition, 2008), pp.379-460.

⁴⁷ Judgment of the Court of 19 November 1991. - Andrea Francovich and Danila Bonifaci and others v Italian Republic. - References for a preliminary ruling: Pretura di Vicenza and Pretura di Bassano del Grappa - Italy. - Failure to implement a directive - Liability of the Member State. - Joined cases C-6/90 and C-9/90. *European Court reports 1991 Page I-05357*. Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61990J0006:EN:HTML>

The ‘passport directives’ have clearly enhanced financial integration in the EU, although areas of marked divergence, such as retail financial services, remained.⁴⁸ But, minimum harmonization left the EU with an incomplete regulatory framework, since, in many cases, it merely augmented rather than replaced pre-existing national laws.⁴⁹ Thus, the drive towards harmonization intensified in the early 2000s, following the introduction of the Euro and the publication of the Commission’s Financial Services Action Plan (FSAP) in 1999.⁵⁰ Arguably, the most important integrative instrument of that era (which can be viewed as the second EU financial services consensus)⁵¹ was the Directive on Markets in Financial Instruments (MiFID), which established a detailed pan-European regime with respect to conditions of establishment and operation of financial markets and investment intermediaries and the conduct of cross-border financial activities.⁵² National implementation of MiFID from 2007 onwards represented the third stage of single market development.⁵³

To answer a number of challenges pertaining mostly to enactment and consistent implementation of financial services legislation, the EU adopted the so-called Lamfalussy process in 2001. It consisted of four levels that started with the adoption of the framework legislation (Level 1) and more detailed implementing measures (Level 2). For the technical preparation of the implementing measures, the Commission was to be advised by the committees made up of representatives of national supervisory bodies from three sectors: banking, insurance

⁴⁸ E. Grossman and P. Leblond, “European Financial Integration: Finally the Great Leap Forward?,” *Journal of Common Market Studies*, 49 (2011), 413-35.

⁴⁹ See for a discussion of this issue and the gaps left behind by minimum harmonization Avgouleas, E (2000). The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection. *European Law Journal*, Vol. 6, pp. 72-92.

⁵⁰ Commission Communication, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM(1999)232. On the important changes FSAP implemented in the field of EU regulation of financial services and its impact on the single market see Ferran, E. (2005). Building an EU Securities Market (CUP, 2005).

⁵¹ On this and for a critical discussion of FSAP legislation see See Avgouleas, E (2005). Evaluation of the New EC Financial Market Regulation: Peaks and Troughs in the Road Ahead. *Transnational Lawyer* Vol. 18, pp. 179-228.

⁵² EC, Directive 2004/39/EC 2004 of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, [2007] O.J. L 145/1. For a discussion of the contours of MiFID see Avgouleas, E (ed.), *The Regulation of Investment Services in Europe under MiFiD: Implementation and Practice* (Tottel, 2008).

⁵³ Mads Andenas, Douglas Arner & Mei-wah Leung, “The Future of the European Single Market for Financial Services” AIFL Working Paper No. 8, online: <http://www.aiifl.com>.

and occupational pensions, and the securities markets. These committees were CEBS,⁵⁴ CEIOPS⁵⁵ and CESR⁵⁶. The level 3 committees would then contribute to the consistent implementation of Community directives in the Member States, ensuring effective cooperation between the supervisory authorities and convergence of their practices (Level 3) and finally, the Commission was to enforce timely and correct transposition of EU legislation into national laws (Level 4).⁵⁷

In the aftermath of the global financial crisis, the EU has introduced a number of pan-European bodies with regulatory competences, the most important of which is the development of a common rulebook.⁵⁸ The new institutions that the EU has built since 2009 are discussed in section III.B.

⁵⁴ The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the European Union was established by the European Commission in 2004 by Decision 2004/5/EC (the Commission's decision dated November 2003 is available at http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l22025_en.htm) On 1 January 2011, this committee was replaced by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the Committee of European Banking Supervisors (CEBS). The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 available at: <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>

⁵⁵ CEIOPS (2003-2010) was established under the European Commission's Decision 2004/6/EC of 5 November 2003. In January 2011 CEIOPS was replaced by EIOPA under the Decision 2009/79/EC in accordance with the new European financial supervision framework.

⁵⁶ The Committee of European Securities Regulators (CESR) was an independent committee of European Securities regulators established by European Commission on June 6 of 2001. On 1 January 2011, CESR was replaced by the European Securities and Markets Authority (ESMA) in accordance with the new European financial supervision framework. See more at <http://www.esma.europa.eu/index.php?page=cesrinshort&mac=0&id=>

⁵⁷ See, Lamfalussy, A. (2001). Final Report of the Committee of Wise Men on the Regulation of European Securities Markets Brussels, 15 February 2001, available at http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf. For a review on the process recommendations, see also, Ferran, E. (2010). Understanding the New Institutional Architecture of EU Financial Market Supervision. In G.Ferrarini, K.J.Hopt & E.Wymeersch (Eds.), *Rethinking Financial Regulation and Supervision in Times of Crisis* (OUP, 2012), Ch. 5, where Ferran examines the recent EU institutional reforms on financial market supervision to assess their significance. See also, Schaub, A. (2004). The Lamfalussy process four years on. *Journal of Financial Regulation and Compliance*, 13(2), 110 - 120.

⁵⁸ See 'Report of the High Level Group on Financial Supervision in the EU', February 2009 (the de Larosière report), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

III. Crisis and Response in the EU

A. The GFC and Eurozone debt crisis

1. Overview

As mentioned earlier, it was not until the 2008 crisis and in earnest after the outbreak of the Eurozone debt crisis in 2010 that the vexed issue of preservation of financial stability in an integrated market came to the forefront of EU policy-makers' attention. Both crises have emphasized the need to revisit existing models of financial market integration with a view of enriching them with institutions and structures that underpin financial stability as well as economic growth. It should be noted here that the Maastricht Treaty (1992) did not include 'financial stability' as a key objective of the ECB, although, article 127(5) of TFEU underscores the 'financial stability' as a classic central banking good. Thus, financial stability has not been designed as one of the four basic tasks to be carried through the ESCB (article 127(2) of TFEU) and has rather been clustered with prudential supervision under the 'non-binding tasks' of the ECB.

Until the onset of the GFC in 2008, the 'common passport facility' was at the heart of the EU single market. The EU legislative framework based on harmonized standards for financial markets sought equivalence among disparate regulatory and legal systems, so that regional initiatives could recognise national legal and regulatory regimes.⁵⁹ But a multi-level governance system involves far more complexities than a regime based on minimum harmonisation can foresee. These mainly arise out of the conflicting and sometimes misunderstood national priorities and transnational requirements. Even before the current crisis, the European Union was viewed by some as a 'too intrusive' and 'remote' institution in need of a more coherent set of policies within existing treaties.⁶⁰

⁵⁹ See, B Steil, *The European Equity Markets: The State of the Union and an Agenda for the Millennium* (Brookings Institution Press, 1996), 113

⁶⁰ COM. (2001). *European Governance - A White Paper*. Brussels: Commission of the European Communities. P12

Political considerations also undermined the credibility of rule-based frameworks for coordination of national fiscal policies in the euro area.⁶¹ For example, the Stability and Growth Pact (SGP) was originally designed to safeguard sound public finances and to thwart individual Eurozone members from adopting fiscal policies leading to unsustainable debt levels by enforcing budgetary discipline. Nonetheless, France and Germany, faced with a breach of the 3 percent deficit limit in 2002-04, pushed through a watering down of the SGP rules by March 2005. Arguably, the Maastricht Treaty itself allowed sufficient flexibility to the interpretation of SGP and its enforcement as to allow it to become part of the political bargaining process in the EU at the expense of objective economic criteria.⁶² As a result, during the period that the debt crisis was building up, the Eurozone was deeply marked by economic and financial imbalances and the Union itself lacked a central fiscal authority, which would have afforded it a credible mechanism to enforce budget discipline. In addition, trade imbalances due to accelerating competitiveness imbalances and lack of exchange rate flexibility meant that there were no realistic prospects for fiscal convergence.⁶³ Yet, preserving, in the long-term, any currency union, including the EMU, requires a sufficient level of economic convergence, together with a properly functioning internal market, and an effective system for economic and budgetary policy surveillance and coordination.

Accordingly, when the GFC broke out with force, European financial stability was hampered by a number of pre-existing problems which had simply been ignored for far too long. These included colossal pre-crisis public and private debt piles, a flawed macroeconomic framework, and absence of institutions capable of handling effectively a cross-border banking crisis. The incomplete institutional design was the true mark of an ‘imbalanced’ and disjointed monetary union, also characterized by the absence of effective fiscal convergence mechanisms. Namely, during the first decade of its life, the EMU was premised on a weak institutional framework that was more suitable to a ‘fair weather currency’,⁶⁴ rather than a monetary union with asymmetrical member economies, which were about to experience massive macro-

⁶¹ See, Bergsten, C. F., & Kirkegaard, J. F. (2012). *The coming resolution of the European crisis [electronic resource]* Peterson Institute for International Economics, Washington, D.C Retrieved from http://www.ciaonet.org/pbei/iie/0024277/f_0024277_19801.pdf

⁶² *European Council Presidency Conclusions, Council of the European Union*. (March 22-23, 2005). Brussels: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf.

⁶³ See P. de Grawe, *Economics of Monetary Union* (OUP, 9th ed., 2012), part 2.

⁶⁴ Bergsten, C. F., & Kirkegaard, J. F. (2012). *Ibid*

economic shocks. It assumed that any macroeconomic or banking system stability shocks could be dealt with at the national level without requiring any transfers from the strongest to the weaker members of the Eurozone, due to the no bailout clause in the EMU Treaty.⁶⁵ Consequently, the outbreak of the sovereign debt crisis in the Eurozone in 2010 meant that the EU had to enter into the most transformative phase of its history.

While the 2008 crisis intensified reform efforts to a great extent, the true big bang for the mooted pan-European supervisory and bank resolution structures has been the ensuing Eurozone debt crisis, which has shaken to its foundations the banking system of the eurozone. The EU had to devise mechanisms, in the midst of crisis, firstly, to prevent an immediate meltdown of its banking sector and ensuing chain of sovereign bankruptcies and, secondly, to reform its flawed institutions, in order to prevent the Eurozone architecture from collapsing. Namely, Eurozone members had to build both a crisis-fighting capacity and support bailout funding mechanisms. This has led to the establishment of a European Financial Stability Facility (EFSF), which will be superseded by the European Stability Mechanism (ESM). At the same time, serious steps have been taken to build a European Banking Union based on structures safeguarding centralization of bank supervision and uniform deposit insurance arrangements, as well as centralization of crisis-resolution.

2. Problems of Integration – Cross-border banking

The premise of home-country control and the principle of minimum harmonization were bound to undermine at some point the stability of the EU banking system. The integration process continued in an increasingly de-regulated market following the intensification of liberalization efforts in the last quarter of the 20th century, but the regulatory standards and supervisory principles were not adjusted to new realities. The Eurozone crisis has brought home with devastating force the potential risks of financial market integration, which inevitably leads financial institutions operating in the single market to develop very tight links of interconnectedness, allowing thus shocks appearing in one part of the market to be transmitted widely and quickly across all other parts. Examples of such rapid transmission of shocks include the failure of Icelandic banks, the botched rescue of Fortis bank, the threat of collapse of the

⁶⁵ See Art. 101 TEU (now enshrined in Art. 125 of the Treaty on the Functioning of the European Union, 2008).

financial systems of Ireland and Spain, and the possibility of a sovereign default (e.g., Greece), or of a chain of sovereign defaults. Each of those crises brought serious tremors to European markets and exposed their fragility and the dearth of policy options available to Eurozone decision-makers. Naturally, the rapid amplification of those crises and their grave consequences has raised serious questions regarding the survival of Eurozone.

In the US the response to the crisis was rapid and came in the form of state purchase of distressed bank assets so-called Troubled Asset Relief Programme (TARP), innovative intervention schemes by the Federal Reserve, and (complex) re-regulation of the financial sector. In the EU however, the diversity of member state economies and issues arising out of inherent contradictions between national policy priorities meant a much lower degree of responsiveness to the crisis. This became evident as soon as some of the EMU states, which experienced a more severe crisis than other members had to adopt policies based on their own national needs and interests – which may not be necessarily have been in conformity with single market policies. For example, lack of common deposit insurance in a well-integrated banking market at a time of cross-border crisis led to several conflicting policy choices and responses in an effort by the states to protect their own citizens.

a. The Icelandic banking crisis

The collapse of the Icelandic banks - Glitnir, Kaupthing and Landsbanki⁶⁶ – which operated branches in EU member states on the basis of the single passport presents a classic case of home country control failure and of the disastrous consequences of lack of centralized supervision and resolution mechanisms in the EU. Iceland's banks expanded in the 2000s in a way that exceeded the small country's GDP by a massive 6:1 ratio. The single passport, also afforded to European Economic Area countries (such as Iceland, which is not an EU member), gave Icelandic banks the ability to expand their assets and deposit base through branches and through internet-based operations offering cross-border banking services. As European depositors were lured by the high interest rates offered by Icelandic banks, gradually Icelandic banks built a large depositor base in certain European countries.

⁶⁶ The collapse followed from difficulties in refinancing their short-term debt and a run on deposits in the Netherlands and the United Kingdom.

However, by 2008 both the country's economy and even more its banks were in serious trouble. While trouble was brewing over several months Icelandic bank operations within the EU were supervised by the home country authorities, which were unwilling to take any radical restructuring or rescue measures, thus, nothing was done to prevent the ensuing panic. So when Icelandic banks faced difficulties in refinancing their short-term debt, a run on the Icelandic bank's deposits in the Netherlands and the United Kingdom became inevitable, as domestic depositors were not covered by the deposit protection scheme of their home countries. While both the Netherlands and the UK, were, in the beginning unwilling to extend protection to Icelandic bank depositors, at the same time, Iceland could provide no comfort to foreign depositors, because it was already in the middle of a deep financial crisis, and its government did not want to pay for the mistakes made by private banks with the assistance of politicians and of 'home' supervisory authorities. Harsh responses followed both from the UK and Netherlands authorities,⁶⁷ which, though entirely necessary, annulled the single passport principle. In order to prevent the crisis spreading to the British banking system the UK Prime Minister, Gordon Brown extended protection to British depositors, which essentially meant that the British deposit protection scheme would cover the loss. Thus, the UK Treasury proceeded with the unprecedented step of issuing a compulsory freezing order of Icelandic bank assets and deposits under the Anti-terrorism, Crime and Security Act 2001, which, of course, antagonized relationships with Iceland. In addition, the UK government announced that it would launch legal action against Iceland over any losses connected to the compensation of an estimated 300,000 UK savers.⁶⁸ Icelandic authorities later reached an agreement separately with both the UK and the government of the Netherlands. Thus, Iceland will be paying the UK and Netherlands a

⁶⁷ The UK used provisions in sections 4 and 14 and Schedule 3 of the Anti-terrorism, Crime and Security Act 2001 to issues a freezing order over Landsbanki assets. The Landsbanki Freezing Order 2008 was passed at 10 am on 8 October 2008 and came into force ten minutes later. Under the order the UK Treasury froze the assets of Landsbanki within the UK, to prevent the sale or movement of Landsbanki assets within the UK, even if held by the Central Bank of Iceland or the Government of Iceland. http://en.wikipedia.org/wiki/2008%E2%80%932012_Icelandic_financial_crisis - cite_note-55 See, Anti-terrorism, Crime and Security Act 2001, retrieved, November 24, 2012 <http://www.legislation.gov.uk/ukpga/2001/24/contents>.

⁶⁸ Marshall, Chris; Martin, Iain (October 08, 2008). "UK government launching legal action against Iceland." <http://www.citywire.co.uk/money/update-uk-govt-launching-legal-action-against-iceland/a316803>, retrieved on November 24, 2011

percentage of GDP from 2019-23 to compensate for the deposit protection made available by these two countries to their own consumers holding deposits in Icelandic banks.

The collapse of Icelandic banks led to economic crisis and the mishandling of the crisis brought down the political machinery of the government. In fact, it seems that requisite malpractice involved abuse of insiders' positions (especially in the case of Kaupthing bank, where in a way the bank was buying its own shares)⁶⁹ and weak supervisory and institutional oversight. Moreover, the Icelandic banking crisis and the more recent Cyprus banking crisis hold serious lessons for Asian countries as they underscore the risks arising from the 'nurturing' of over-grown financial sectors which much outstrip a country's GDP, although this irrefutable does place smaller country industries into a disadvantageous competitive position.⁷⁰

b. The botched rescue of Fortis Bank

When the collapse of Lehman Brothers hit global markets, Fortis -- a big European bank with strong cross-border presence in France, the Netherlands, Belgium and Luxembourg -- came very close to collapse.⁷¹ In Belgium, Fortis was the country's biggest private sector employer and more than 1.5 million households -- about half the country -- banked with the group. In 2007, Fortis had acquired parts of ABN AMRO through a consortium with Royal Bank of Scotland and Santander. In 2008, Fortis had difficulties realising its plans to strengthen its financial position. Over the summer of 2008, its share price deteriorated and liquidity became a serious concern.

⁶⁹ The investigation is expected to focus on a number of questionable financial practices engaged in by Icelandic banks including the following: (a). Almost half of all the loans made by Icelandic banks were to holdings companies, many of which are connected to those same Icelandic banks. (b). Money was allegedly lent by the banks to their employees and associates so they could buy shares in the banks while simply using the same shares as collateral for the loans. Borrowers were then allowed to defer paying interest on the loan until the end of the period, when the whole amount plus interest accrued was due. These same loans were then allegedly written off days before the banks collapsed. (c). Kaupthing allowed a Qatari investor to purchase 5% of its shares. It was later revealed that the Qatari investor "bought" the stake using a loan from Kaupthing itself and a holding company associated with one of its employees. See, Liu, Q., Lejot, P., & Arner, D. A. (2013), forthcoming

⁷⁰ Another lesson that the Icelandic banks crisis might hold is that default in the face of mounting and unreasonable debt might not be such a bad thing. By mid-2012 Iceland is regarded as one of Europe's recovery success stories. It has had two years of economic growth. Unemployment is down to 6.3% and Iceland is attracting immigrants to fill jobs.

⁷¹ Basel Committee on Banking Supervision (BCBS), 'Report and Recommendations of the Cross-border Bank Resolution Group', Basel, September 2009, p. 10.

Insolvency fears saw Fortis' shares to fall to their lowest level in more than a decade and its shares gradually lost more than three-quarters of their value.

Fortis was deemed to be systemically relevant in the three countries. Thus, the ECB and ministers from the Netherlands, Belgium and Luxembourg agreed to put 11.2bn euros (\$16.1bn; £8.9bn) into Fortis to save the bank. As part of the weekend deal to rescue Fortis, the bank would have to sell its stake in the Dutch bank ABN Amro, which it had partially taken over the previous year. The Fortis deal would have seen Belgium contribute 4.7bn euros, the Netherlands 4bn euros and Luxembourg 2.5bn euros. However, European bank shares fell sharply on worries that other banks could have problems, and on concerns over the 700bn dollars bailout plan in the United States (TARP). One of the biggest casualties was Fortis' rival Dexia, which French and Belgian governments also promised to step in to support. Eventually the joint rescue of Fortis broke down along national lines and each of the three countries (Belgium, the Netherlands, Luxembourg) concentrated only on the part of the group that was most important for their market,⁷² in defiance of single market principles/ideals.

3. The Eurozone debt crisis

In Europe, the banking and liquidity crisis soon transformed into a complex and multilayered crisis. As soon as a series of public bailouts took the issue of the continuing solvency of UK, US, and major European banks out of the limelight, the state of Irish and Spanish banks and the possibility of a Greek default brought the lurking woes of the Eurozone into sharp focus. Ireland

⁷² (Emphasis added). The Dutch government purchased Fortis Bank Netherlands, Fortis Insurance Netherlands, Fortis Corporate Insurance and the Fortis share in ABN AMRO. The Belgian government raised its holding in Fortis Bank Belgium up to 99%. 'The Belgian government also agreed to sell a 75% interest to BNP Paribas (BNP) in return for new BNP shares, keeping a blocking minority of 25% of the capital of Fortis Bank Belgium. BNP also bought the Belgian insurance activities of Fortis and took a majority stake in Fortis Bank Luxembourg. A portfolio of structured products was transferred to a financial structure owned by the Belgian State, BNP and Fortis Group.' BCBS, Report and Recommendations, p. 10. On 12 December 2008, the Court of Appeal of Brussels suspended the sale to BNP, which was not yet finalised, and decided that the finalised sales to the Dutch State and to the Belgian State as well as the subsequent sale to BNP had to be submitted for approval by the shareholders of Fortis Holding in order for these three sales to be valid under Belgian Law. After initial rejection by the shareholders, certain transactions were renegotiated and financing of the portfolio of structured products was modified. The renegotiated transaction with the Belgian State and BNP was approved at the second general meeting of shareholders and the latter transaction was finalised on 12 May 2009. Ibid.

and Greece have essentially triggered the second and more lethal wave of the crisis of confidence that has hit most of Europe since 2010 - although Italy and Spain might in the end prove much bigger threats to Eurozone's survival than Greece, Portugal and Ireland, which represent only a very small fraction of Eurozone GDP. The Eurozone crisis should be seen as a sequence of four interlocking crises resulting from imbalanced monetary integration. This resulted in a competitiveness crisis that transformed into a marked loss of fiscal revenues and widening fiscal deficits which led to debt accumulations (particularly in Greece, Italy, Portugal, and Spain) that were financed by the surpluses of the northern countries, reflecting, in turn, to massive payment imbalances within the Eurozone (in particular, Germany, the Netherlands, and Finland vis-à-vis the European South). As said surpluses had to be re-invested, they found their way to investments in the bonds of deficit countries (Greece, Italy) or to the banking systems of the Eurozone periphery (Ireland, Spain) and financed gigantic real estate bubbles in Ireland and Spain. Thus, they led to accumulation of unsustainable levels of public or private debt or both.⁷³

Eurozone economies continue to suffer from the impact: the sharp recessions of 2008-09 and subsequent economic slowdowns coupled with sovereign debt crises have had a sharply negative impact on their fiscal position which has been further aggravated by the operation of automatic fiscal stabilizers and the counter-cyclical fiscal measures adopted during the crisis. The EU-wide general government deficit has increased from 1 percent of GDP in 2007 to 6.8 percent of GDP in 2009. At the same time, the Eurozone's⁷⁴ aggregate debt-to-GDP ratio also deteriorated markedly, rising from 61.8 percent of GDP by 2007 to a projected 82.3 percent in 2011 to 90.0 percent of GDP by the second quarter of 2012, whereas for the EU-27,⁷⁵ the ratio stood at 84.9 percent of GDP at the end of same period.⁷⁶ The European Commission's long-

⁷³ Avgouleas, E. (July 2012). Eurozone Crisis and Sovereign Debt restructuring: Intellectual Fallacies and New Lines of Research. Paper presented at the Society of International Economic Law (SIEL), 3rd Biennial Global Conference, Centre for International Law (CIL) and Faculty of Law, at National University of Singapore.

⁷⁴ The euro area (EA17) includes Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

⁷⁵ The EU27 includes EA 17 plus Bulgaria, the Czech Republic, Denmark, Latvia, Lithuania, Hungary, Poland, Romania, Sweden and the United Kingdom

⁷⁶ Euro area government debt up to 90.0% of GDP. (2012) *Eurostat News Release: Euroindicators* (Vol. 150/2012-24October). Eurostar Press office, retrieved from http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-24102012-AP/EN/2-24102012-AP-EN.PDF.

term projections indicate that debt-to-GDP ratio could rise to around 110 percent by 2030 in the absence of appropriate fiscal consolidation plans.⁷⁷

Following the escalation of the sovereign debt crisis in the second half of 2011, the EU economy entered a shallow recession by the fourth quarter of the same year. Since then, the outlook for the EU economy slowly improved in the beginning but the situation became extraordinarily fragile and by mid-2012 the risk of a renewed crisis became more evident. The intensification of the sovereign-debt crisis in the first half of the year, raised market concerns about the long-term viability of the euro area itself and the negative fall-out from banks' funding pressures and economic activity, together with an unexpected slowdown in non-EU GDP growth and global trade contributed to an overall disappointing global growth performance. The annual GDP growth rate predicted is 0.5 percent for the EU in 2013, whereas GDP in the Eurozone will remain unchanged.⁷⁸ The weak short-term growth outlook raises concerns for the labour markets, where a further rise in already very high unemployment rates appears likely for this year as Italy, Portugal, Greece, Cyprus, Portugal and Spain implement austerity measures to reduce their debt through asset sales and reduced spending in social welfare programs.

The Eurozone crisis has signaled a fundamental shift in the political dynamics underpinning the EU. While the exact remedies of the crisis, austerity, more integration, mutualization of Eurozone members' debt and other measures remain the topic of heated discussion, one remedy is viewed as uncontroversial. Namely, it is quite beyond dispute that the Eurozone crisis would have been much less severe, if Eurozone members could find a way to break up the link between bank debt and sovereign indebtedness, which, of course, created a vicious circle of ever more bank bailouts and ever-higher levels of national debt. The fact that many EU banks had invested in EU members' bonds and are also adversely affected by the continuous recession ravaging the periphery of the Eurozone has only made things worse. However, the EMU, although it had interest rate setting competence through the European Central Bank, has until recently been devoid of any binding mechanism to effectively enforce fiscal and banking stability, both areas of serious national interest where pooling of sovereignty

⁷⁷ Arroyo, H. T. (2011). The EU's Fiscal Crisis and Policy Response: reforming economic governance in the EU Directorate General for Economic and Financial Affairs, European Commission, available at <http://www.oecd.org/gov/budgetingandpublicexpenditures/48871475.pdf>

⁷⁸ EU. (Autumn 2012). European Economic Forecast (Vol. European Economy: 7|2012). European Commission: Directorate-General for Economic and Financial Affairs.

was regarded, until recently, as intolerable. Namely, since its establishment the EMU lacked these crucial supporting institutions that could have helped it to restore financial stability during times of acute uncertainty and market volatility.⁷⁹ More specifically, the EMU lacked suitable institutions that could absorb liquidity shocks, due to a collapse of confidence in the prospects of a member state's economy, and cross-border supervisory and resolution structures that could effectively deal with the cross-border spillover effects of a bank collapse.

In order to break the vicious circle between bank bailouts and levels of sovereign indebtedness, the Eurozone members have established a funding facility, the European Stability Mechanism (ESM), which, subject to a strict conditionality, will be employed to directly recapitalize Eurozone banks. The use of ESM funds for such recapitalisations would put to a stop to further increases of the indebtedness of the sovereign concerned due to bank bailouts. The inevitable transfer of payments from the richer to the weaker Eurozone members through the ESM, which enjoys the guarantee of all Eurozone members, and the need to tighten the framework for bank regulation, supervision, and resolution have meant that the countries in the core of the Eurozone have promoted the centralization of bank supervision and resolution functions in the EMU. These demands have given birth to a new set of bank authorization, supervision and resolution arrangements: the European Banking Union. However, the European Banking Union, plausible and necessary as it may be, has also reinforced rather than calmed the centrifugal forces within the EU and has the potential to lead to a serious split of the internal market.⁸⁰ Important members of the EU, chiefly the UK, have resolutely remained outside important European Banking Union arrangements. It is, thus, reasonable to infer that political expediency, and not economic necessities, will, in the end seal the fate of the single currency.

B. EU Financial Regulation Infrastructure in the post- 2009 period: From Evolution to Revolution

1. *Phase I: From the Lamfalussy Process to the ESFS*

⁷⁹ Bergsten, C. F., & Kirkegaard, J. F. (2012). *The coming resolution of the European crisis [electronic resource]* Peterson Institute for International Economics, Washington, D.C Retrieved from http://www.ciaonet.org/pbei/ie/0024277/f_0024277_19801.pdf

⁸⁰ Lastra, R. (2013). Banking Union and Single Market: Conflict or Companionship?, *Fordham International Law Journal*, Vol. 36, forthcoming.

In November 2008 the Commission appointed a High Level Group (chaired by Jacques de Larosiere) to study the Lamfalussy framework in light of the GFC and the threats to cross-border banking and the internal market that the GFC uncovered, and to make recommendations for a new EU regulatory set up.⁸¹ The proposals advanced by the de Larosiere report were instrumental to subsequent developments. In order to implement the recommendations of the de Larosiere committee the EU established (through a series of Regulations, normally referred to as the ESAs founding Regulations) an integrated European System of Financial Supervision (ESFS), which came into effect in December 2010.⁸² It comprises the European Systemic Risk Board⁸³ and a decentralized network comprising existing national supervisors (who would continue to carry out day-to-day supervision) and three new European Supervisory Authorities (ESAs): the European Banking Authority (EBA),⁸⁴ the European Insurance and Occupational Pension Authority (EIOPA), and the European Securities Markets Authority (ESMA), which respectively replaced the corresponding Lamfalussy Level 3 Committees: CEBS,⁸⁵ CEIOPS⁸⁶

⁸¹ Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. Brussels: European Union.

⁸² Article 2, ESA founding Regulations, see, Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC. (2010) (pp. 84-119): Official Journal of the European Union, available at http://www.esma.europa.eu/system/files/Reg_716_2010_ESMA.pdf.

⁸³ The European Systemic Risk Board (ESRB), established on 16 December 2010 in response to the ongoing financial crisis. It has been tasked with the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union. It was established under the EU Regulation No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation'). The Regulation is available at <http://www.esrb.europa.eu/shared/pdf/ESRB-en.pdf?efba86ec695eea33d6b673acc62578d9>

⁸⁴ The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 available at: <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>

⁸⁵ The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the European Union was established by the European Commission in 2004 by Decision 2004/5/EC (the Commission's decision dated November 2003 is available at http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l22025_en.htm) On 1 January 2011, this committee was succeeded by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the Committee of European Banking Supervisors (CEBS).

and CESR.⁸⁷ Furthermore, colleges of supervisors⁸⁸ were to be put in place for all major cross-border institutions because supervision of strategic decisions at the consolidated level requires a college of supervisors to understand the global effects and externalities of those decisions.⁸⁹ Last but not least, a Joint Committee⁹⁰ was formed by the European Supervisory Authorities to coordinate their actions on cross-sectoral rule-making and supervisory matters. It was envisaged that in addition to the competences previously exercised by the Level 3 committees, the ESAs should have, inter alia, the following key competences⁹¹:

- i) Legally binding mediation between national supervisors,
- ii) Adoption of binding supervisory standards,
- iii) Adoption of binding technical decisions applicable to individual financial institutions,
- iv) Oversight and coordination of colleges of supervisors,
- v) Designation, where needed, of group supervisors,

⁸⁶ CEIOPS (2003-2010) was established under the European Commission's Decision 2004/6/EC of 5 November 2003, which has been replaced by EIOPA.

⁸⁷ The Committee of European Securities Regulators (CESR) was an independent committee of European Securities regulators established by European Commission on June 6 of 2001. On 1 January 2011, CESR was replaced by the ESMA.

⁸⁸ The colleges are a mechanism for the exchange of information between home and host authorities, for the planning and performance of key supervisory tasks in a coordinated manner or jointly, including all aspects of ongoing supervision, and also for the preparation for and the handling of emergency situations.. These are permanent, although flexible, structures for cooperation and coordination among the EU authorities responsible for and involved in the supervision of the different components of cross-border groups, specifically large groups. See further at <http://www.eba.europa.eu/Supervisory-Colleges/Introduction.aspx> and, Colleges of Supervisors – 10 Common Principles. (January 27, 2009) (Vol. CEIOPS-SEC-54/08, CEBS 2008 124, IWCFC 08 32): <http://eba.europa.eu/getdoc/aeeacaf1a-81b5-476a-95dd-599c5e967697/Clean-V3-formatted-CEBS-2008-124-CEIOPS-SEC-08-54-.aspx>.

⁸⁹ In a sense this followed similar propositions as to how regulation of cross-border banking in the EU had to be structured. See, Lamanda, C. (March 2009). Cross-Border Banking in Europe: what regulation and supervision? *Unicredit Group Forum on Financial Cross-border Groups, Discussion paper No 01*, available at https://www.unicreditgroup.eu/content/dam/unicreditgroup/documents/inc/press-and-media/cross_border_banking_discussion_paper.pdf. Lamanda's Report had suggested that the supervision of cross-border banks had to be based on three tiers: day-to-day supervision to continue with national supervisors as it requires supervisors to be close to a business; strategic decisions, affecting the entire group to be supervised by colleges of supervisors, with enhanced, legally binding supervisory powers for each cross-border institution; and, a European Banking Authority (EBA), whose independence, governance and mechanisms follow the proposal of the de Larosiere Group.

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⁹¹ For comprehensive analysis, see Avgouleas, E. (2012). *Governance of Global Financial Markets: the law, the economics, the politics*. Cambridge: Cambridge University Press.

- vi) Licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures), and
- vii) Binding cooperation with the ESRC to ensure adequate macro-prudential supervision.

ESAs' work with the newly established European Systemic Risk Board (ESRB) to ensure financial stability and to strengthen and enhance the EU supervisory framework. Apart from issuing guidance and recommendations to national supervisors,⁹² ESAs also seek to formulate a single EU rulebook and harmonise technical standards on the basis of powers conferred by the EU commission,⁹³ which subsequently will be adopted by the European Commission to become formal/binding EU law.⁹⁴ To safeguard consistent application of harmonized legislation, if the ESAs find a national supervisory authority failing to apply EU law, they have the power to investigate infractions, with the relevant Authority having the power to directly issue recommendations to national supervisors to remedy potential infractions, followed by a formal opinion from the Commission (if the recommendation is not acted upon). If the supervisor does not comply with the Commission's formal opinion, the ESA may then take decisions directly binding on firms or market participants concerned to ensure that they comply with EU law. In adverse situations, ESAs have wider-ranging powers.⁹⁵ In a crisis, the ESAs will provide EU-wide coordination.⁹⁶ If an emergency is declared, the ESAs may make decisions that are binding on national supervisors and on firms. The ESAs will mediate in certain situations where national supervisory authorities disagree. If necessary, they will be able to resolve disputes by making a decision that is binding on both of the parties to ensure compliance with EU law.⁹⁷ They have a role in EU supervisory colleges to ensure that they function efficiently and that consistent approaches and practices are followed.⁹⁸ The ESAs will conduct regular peer reviews of national

⁹² Article 8, defining tasks and powers of the Authority; See also, Article 10-17, ESA founding Regulations.

⁹³ Article 11, exercise of delegation, ESA founding Regulations.

⁹⁴ Article 10, Regulatory Technical Standards, ESA founding Regulation.

⁹⁵ Article 18, Action in emergency situations, ESA founding Regulations.

⁹⁶ Article 31, Coordination function, ESA founding Regulations.

⁹⁷ Article 19, Settlement of disagreements between competent authorities in cross-border situations, and also, Article 20, Settlement of disagreements between competent authorities across sectors; Article 21, Colleges of supervisors, ESA founding regulations.

⁹⁸ Article 29, Common supervisory culture; Article 27, European system of resolution and funding arrangements, ESA founding Regulations.

supervisory authorities across the EU.⁹⁹ They will be able to collect information from national supervisors to allow them to fulfill their role.¹⁰⁰ This information will be used for analyzing market developments, coordinating EU-wide stress tests and the macro prudential analysis undertaken by the ESRB.¹⁰¹ They also have a remit to consider consumer protection issues.¹⁰² In the ensuing paragraphs we provided a more analytical overview of the competences discharged by the ESRB and the ESAs.

a. The European Systemic Risk Board (ESRB)

One of the recommendations of the de Larosiere report was to take stock of systemic risk factors that have been affecting the stability of the EU financial system as a whole. This made necessary the establishment of a EU-level body tasked with macro-prudential risk assessment. On 16 December 2010, Regulation (EU) No 1092/2010 established a European Systemic Risk Board (the ESRB Regulation) as an independent body with no legal personality and with no legally binding powers, hosted by the ECB, which directs its work and chairs the meetings. The ESRB might, in fact, be the most pertinent of EU reforms in the East Asian context, given that the level of integration and harmonization of financial sector regulations lags considerably behind that of the EU.

The ESRB aims at detection of excessive risk accumulation, improving surveillance and supervision. Thus, its principal task is to conduct operations consisting of prediction, assessment management, and prevention and control of systemic risk and to collect and analyze all the relevant and necessary information, identify and prioritize systemic risks,¹⁰³ issue warnings

⁹⁹ Article 30, Peer reviews of competent authorities, ESA founding Regulations.

¹⁰⁰ Article 36, Relationship with the ESRB, ESA founding Regulations.

¹⁰¹ Article 36, Relationship with the ESRB, and, Article 23 Identification and measurement of systemic risk, ESA founding Regulations. See also Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board. (2010) *Official Journal of the European Union* (Vol. L331/1): available at <http://www.esrb.europa.eu/shared/pdf/ESRB-en.pdf?49c9d3be4e6566e3eb2c1f0b210d4980>. [Hereinafter ESRB Regulation].

¹⁰² Article 9, Tasks related to consumer protection and financial activities; Article 26, European system of national Investor Compensation Schemes, ESA founding Regulations.

¹⁰³ Article 3, ESRB Regulation.

where such systemic risks are deemed to be significant,¹⁰⁴ and, issue recommendations for remedial action and, where appropriate, making those recommendations public.¹⁰⁵ The ESRB can determine an emergency situation where it may issue a confidential warning addressed to the European Council. This should provide the Council with an assessment of the situation¹⁰⁶ in order to enable the Council to adopt a decision addressed to the European Supervisory Authorities (ESAs) determining the existence of an emergency situation.¹⁰⁷ It is for the Council – and not for the ESRB, which serves only the advisory function- to make decisions on such emergencies. The ESRB works in close cooperation with several other parties to the European System of Financial Supervision (ESFS),¹⁰⁸ including the EU Commission and EU Economic and Financial Committee (EFC) for surveillance.¹⁰⁹ Jointly with the European Council it performs a collective oversight for systemic stability policies and it co-operates with the IMF, BIS, and FSB to identify and assess SIFIs in the EU.¹¹⁰ Moreover, in collaboration with the ESAs, it maintains a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk.¹¹¹

Naturally, there are ambiguities surrounding the ESRB's role. First, ESRB's very low visibility almost two years after it 'opened for business', shows that, in practice, it is not the paramount macro-prudential regulator in the EU. Secondly, since it is a soft law body with informal status, it is very much dependent for information collection on national supervisory and regulatory authorities. The ESRB's dependence on other bodies to carry out some of its tasks and above all its mandate also implies that it may easily become involved in national and European level political struggles and reputation damaging litigation. Secondly, because of the ESRB's closeness with the ECB, which is the effective lender of last resort in the Eurozone, its

¹⁰⁴ Article 3, and Article 16, ESRB Regulation.

¹⁰⁵ Article 3 and Article 16, ESRB Regulation.

¹⁰⁶ Article 3, ESRB Regulation.

¹⁰⁷ Recital 22, ESRB Regulation

¹⁰⁸ Article 16, ESRB Regulation.

¹⁰⁹ See, Dierick, F., Lennartsdotter, P., & Favero, P. D. (2012). The ESRB at work—its role, organization and functioning. Macro-prudential Commentaries, ESRB(1), available at http://www.esrb.europa.eu/pub/pdf/commentaries/ESRB_commentary_1202.pdf

¹¹⁰ Article 3, ESRB Regulation.

¹¹¹ Article 3, ESRB Regulation.

credibility and independence may further be compromised by the ECB's policy priorities.¹¹² It should be noted here that the ECB – unlike traditional central banks who are endowed with powers to employ both monetary policy and LoLR instruments in response to financial crisis – though it has a clear role with respect to monetary policy (Article 127(2) TFEU, and Article 18 of the ESCB Statute), it has a very limited mandate vis-à-vis the discharge of LoLR powers. Also, until the ESM moves into full action, only fiscal authorities can effect bailouts using taxpayers' money.¹¹³ The absence of fiscal union/ powers in the Eurozone therefore, poses an additional constraint to the ECB apart from the restrictions that the Treaty itself provides to deliver effectively as LoLR in Eurozone crisis.

b. European Banking Authority (EBA)

The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010¹¹⁴ and has officially started operations as of 1 January 2011. Having taken over the tasks and responsibilities of the Committee of European Banking Supervisors (CEBS), EBA acts as a hub and support network of EU and member state national bodies, safeguarding the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.

Regulation, oversight, and consumer Protection are the core functions of the EBA as laid down in the EBA Regulation. The fundamental objective of EBA is to develop a single European supervisory and recovery and resolution rulebook, in order to achieve a level playing field for financial institutions and raise the quality of financial regulation and the overall functioning of the Single Market. EBA's oversight activities focus on identifying, analyzing and addressing key

¹¹² Avgouleas, E. (2012). Another perspective is raised by Goodhart and Franklin Allen et.al., who argue that the ECB might not necessarily be a 'tougher supervisor' than national authorities. See Goodhart, C. and Allen, F. in Beck, T. (2012). *Banking Union for Europe Risks and Challenges*, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf Pp 105-119

¹¹³ See, Goodhart, C. (2003). The Political Economy of Financial Harmonisation in Europe. In J. Kremer, D. Schoenmaker & P. Wierst (Eds.), *Financial Supervision in Europe*: Cheltenham: Edward Elgar.

¹¹⁴ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC. (Vol. 331/12): Official Journal of the European Union, available at <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>.

risks in the EU banking sector to strengthen European supervision of cross-border banking groups. EBA is also committed to enhance consumer protection and promote transparency, simplicity and fairness for consumers of financial products and services across the Single Market.¹¹⁵

c. Evaluation

The ECB together with the Central Banks of the EU Member States (NCBs) comprises the European System of Central Banks (ESCB). This configuration produces in itself structural complexity,¹¹⁶ which has its roots in the dual role performed by the NCBs. The NCBs are national agencies while performing non-ESCB functions and at the same time, NCBs constitute an important part of the ESCB and play a role in the conduct of EMU monetary policy. This functional complexity has deeper roots that relate to their constitutive laws. Whereas the ECB operates solely under the EC law, while the status of the NCBs is governed by both the EC law and national legislation. In addition, no provision was made, until the advent of the EBU, for the ECB to have any regulatory oversight over cross-border banks. The ESFS did not remedy the ‘mismatch’ between the geographic scope of European bank activities and the regulatory remit of the authorities supervising them. On the contrary, the ESFS might be accused of just providing yet another layer of complexity in the EU structures. Therefore, even after the implementation of the de Larosiere reforms, cross-border supervision and bank resolution at the EU level remained decentralized and in want of further clarifications as to how ESAs would be able to control and manage their complicated tasks when parties involved would include non-EU countries.

Finally, the structures developed under the ESFS for cross-border bank supervision remain complex and involve too many levels of over-lapping competences that may lead to critical delays during a crisis.¹¹⁷ And then, if any major European bank or a financial institution

¹¹⁵ See, EBA Work Program 2013. (28 September 2012) (Vol. EBA BS 2012 163 FINAL): The European Banking Authority, available at <http://www.eba.europa.eu/cebs/media/aboutus/Work%20Programme/EBA-BS-2012-163-FINAL--EBA-work-programme-for-2013-.pdf>.

¹¹⁶ Lastra, R. M., & Louis, J.-V. (2013).

¹¹⁷ E.g., Jamie Dimon has raised a very pertinent question with respect to the effectiveness of regulatory reforms: “has anyone bothered to study the cumulative effect of these regulatory and market fixes?” on June 07, 2011. Ben Bernanke, the Fed Chairman issues a statement, as reproduced by Barth, “the central bank doesn’t have the quantitative tools to study the net impact of all the regulatory and market changes

fails, it would certainly have repercussions outside EU,¹¹⁸ though no provision is made for formalized cooperation structures with third country regulators beyond those provided in the (informal) context of the G20 and the Financial Stability Board. The most important international co-operation issue is of course the need to draw up clear fiscal burden sharing arrangements.¹¹⁹

Moreover, even under the EFSF extensive reliance is being placed on the judgment and decisions of the home supervisor.¹²⁰ A binding mediation mechanism is required to deal with such cross-border supervisory problems. Without such an effective and binding mechanism, some Member States might in the future try to limit the branching activities of any firm regulated only by a home supervisor, who is judged to have failed to meet the required standards of supervisory practice. Such fragmentation would represent a major step backwards for the Single Market.¹²¹

over the last three years...It's too complicated" to study the new regulations' effect. Reproduced in Barth, J. R., & Prabha, A. P. (December 03, 2012). Moreover, James Barth contends that not everyone is convinced of the new regulations in place (in case of the US, the Dodd-Frank Act) has solved the too-big-to-fail problem, yet, the biggest banks have not been downsized despite the presence of a general consensus from various stake-holders. He quotes from Sheila Bair (Former FDIC Chair, Fortune, February 06, 2012), Richard Fischer & Harvey Rosenblum (FRB of Dallas, Wall Street Journal, April 4, 2012), and, Simon Johnson (Professor at MIT, Bloomberg, October 10, 2011). See, Barth, J. R., & Prabha, A. P. (December 03, 2012). *Breaking (Banks) Up is Hard to Do: New Perspectives on Too Big to fail*. Financial Institutions Centre. Retrieved from <http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf>

¹¹⁸ See, Beck, T. (25 October 2011). *The Future of Banking, A VoxEU.org eBook* Retrieved from http://www.voxeu.org/sites/default/files/file/the_future_of_banking.pdf

¹¹⁹ Goodhart and Schoenmaker have proposed binding burden-sharing arrangement among national governments. If a cross-border bank faces difficulties, the governments would share the costs according to some predetermined key – for example, according to the distribution of the troubled bank's assets over the respective countries. Under such a burden sharing approach, a common solution can be found upfront. By pre-committing to burden sharing, governments would give up some of their sovereignty, but in return, the single market in banking serving Europe's businesses and consumers would be saved. Goodhart, C. A. E., & Schoenmaker, D. (2006). Burden Sharing in a Banking Crisis in Europe. *Sveriges Riksbank Economic Review*, 2, 34-57. This proposal was refined and suggested to become an integral part of group level recovery and resolution plans for cross-border banks in Avgouleas, E, Goodhart, C. & Schoenmaker, D. (2013). Bank Resolution Plans as a Catalyst for Global Financial Reform. *Journal of Financial Stability*, 9, in press.

¹²⁰ See, Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. European Union, Brussels, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

¹²¹ EU. (June 22, 2012). Country-specific recommendations on economic and fiscal policies: The European Semester, 2012. Luxembourg: Council of the European Union, available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/131135.pdf.

2. *Phase II: From the ESFS to the European Banking Union: Overview of EU Reforms in the post-2011 era*

The nature of the regulatory architecture itself may not be an important cause of a financial crisis. Yet the ‘institutional design’ can be very important for the prevention and resolution of a major financial crisis. Prevention is dealt with through a framework of systemic risk control and robust prudential regulations. Crisis management and resolution, on the other hand, require established supervisory and resolution structures, which in an integrated market, must have a cross-border remit, in order to override or subsume the principle of home country control.¹²² For a very long time and until the different pillars of the European Banking Union come into place, the regulatory structures of the EU have been characterized by three principles: decentralization, lack of coordination and segmentation. A careful look at the developmental phase of European institution-building reveals this has been a process of experimentation rather than design.¹²³ The preceding analysis of the crisis and of the responses to it has shown that the inadequacies of the EU financial and institutional framework have played an important role in undermining the stability of the Eurozone financial sector during the crisis.

The EU Treaties did not establish clear institutional borders as a prerequisite for the efficient functioning of ‘multilevel European governance’. This flaw was most evident in the Eurozone sovereign debt crisis. European responses to this crisis highlighted the current role of and power balance among EU institutions and Member States where the Union continues only to react to, and very rarely foresees, urgent needs and international developments which call for a speedy reaction. ‘Who does what’ in Europe has been occupying policy-makers for many years.¹²⁴ A ‘competence catalogue’ was included in the Lisbon Treaty, in force since 1 December

¹²² Garicano, L., & Lastra, R. M. (2010). Towards a New Architecture for Financial Stability: Seven Principles. *Journal of International Economic Law*, 13(3), 597-621. See also, The new supervisory framework in the EU, see Arroyo, H. T. (2011). The EU’s Fiscal Crisis and Policy Response: reforming economic governance in the EU Directorate General for Economic and Financial Affairs, European Commission, available at <http://www.oecd.org/gov/budgetingandpublicexpenditures/48871475.pdf>

¹²³ Schoemaker, D. (19 December 2009). The financial crisis: Financial trilemma in Europe VOX: Research-based policy analysis and commentary from leading economists. <http://www.voxeu.org/article/financial-crisis-and-europe-s-financial-trilemma>

¹²⁴ COM. (2001). *European Governance - A White Paper*. Brussels: Commission of the European Communities.

2009. This distinguishes between EU and the member state powers/competences on the basis of the principle of conferral and recognition. Essentially, for the first time in EU's history it has been explicitly enshrined in the Treaties that competences not conferred upon the Union remain with the Member States.¹²⁵

The EU, as a whole, has embarked on to a number of initiatives to build an integrated surveillance framework with respect to: (a) the implementation of fiscal policies under the Stability and Growth Pact to strengthen economic governance and to ensure budgetary discipline, and, (b) the implementation of structural reforms. As a first step, Eurozone Heads of State adopted the intergovernmental Euro Plus Pact, to strengthen the economic pillar of EMU and achieve a new quality of economic policy coordination, with the objective of improving competitiveness and thereby leading to a higher degree of convergence. As this remains outside the existing institutional framework a constitutional amendment to the EMU will be required to implement it.¹²⁶ In addition, the European Parliament and the Council adopted a 'six-pack' set of new legislative acts, aimed at strengthening the Eurozone's economic governance by reduction of deficits through tighter control of national finances.¹²⁷ The reforms represented the most

¹²⁵ Wouters, J., & Ramopoulos, T. (2012).

¹²⁶ Conclusions of the European Council, 24–25 March 2011, EUCO 10/1/10 REV 1, and subsequently revised conclusions, EU. (January 25, 2012). Conclusions of the European Council, December 09, 2011 (Vol. EUCO 139/1/11 REV 1).

¹²⁷ The legislative 'six-pack' set of European economic governance architecture reforms comprised five regulations and one directive, proposed by the European Commission to come into force on 13 December 2011. See, Regulation (EU) No 1173/2011 of the European Parliament and of the Council of November 16, 2011 on the effective enforcement of budgetary surveillance in the euro area, OJ 2011, L 306/1; Regulation (EU) No 1174/2011 of the European Parliament and of the Council of November 16, 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ 2011, L 306/8; Regulation (EU) No 1175/ 2011 of the European Parliament and of the Council of November 16, 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ 2011 L 306/12; Regulation (EU) No 1176/2011 of the European Parliament and of the Council of November 16, 2011 on the prevention and correction of macroeconomic imbalances, OJ 2011 L 306/25; Council Regulation (EU) No 1177/2011 of November 08, 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ 2011 L 306/25; Council Directive 2011/85/EU of November 08, 2011 on requirements for budgetary frameworks of the Member States, OJ 2011 L 306/41. Available at http://ec.europa.eu/economy_finance/economic_governance/index_en.htm See also Regulation (EU) No 1175/2011 of the European Parliament and of the Council of October 04,

comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the EMU almost 20 years ago. This legislative package aims at concrete and decisive steps towards ensuring fiscal discipline to stabilize the EU economy and to avert new crisis in future.

Moreover, the EMU is currently in the process of adopting a number of radical institutional reforms with a view of addressing the existential challenges it is facing. Radical measures have been adopted, which aim at stabilizing market conditions and containing the impact of the Eurozone debt crisis on the banking system and vice versa, containing negative feedback loops between banks and sovereigns.¹²⁸ Breaking up the vicious circle of bank debt piling up on sovereign debt is a matter of utmost importance for the survival of the Eurozone. EU members need to complete the adjustment of internal and external imbalances, to repair financial sectors and to achieve sustainable public finances.¹²⁹ The economic and financial crisis has exacerbated pressure on the public finances of EU Member States where 23 out of the 27 Member States fall in the so-called ‘excessive deficit procedure’ (EDP). EDP is a mechanism established by the EU Treaties obliging countries to keep their budget deficits below 3% of GDP and government debts below 60 percent of GDP. Accordingly, the Member States running any excess deficit must comply with the recommendations and deadlines as decided by the EU Council to correct their excessive deficit.¹³⁰ Piling up debt in their effort to bail out Europe’s ailing banks only makes things worse. In addition, it raises the cost of borrowing for Eurozone members to unsustainable levels, necessitating continuous bailouts by the wealthier members of

2011 amending Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ 2011 L 306/12, at 15–16.

¹²⁸ See also, Ferran, E. (2010). Understanding the New Institutional Architecture of EU Financial Market Supervision. In G.Ferrarini, K.J.Hopt & E.Wymeersch (Eds.), *Rethinking Financial Regulation and Supervision in Times of Crisis* (OUP, 2012).

¹²⁹ EU. (Spring 2012). European Economic Forecast (Vol. European Economy: 1|2012). European Commission: Directorate-General for Economic and Financial Affairs, available at http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf

¹³⁰ There is however, mounting criticism of the conditionality of deficit reduction by pursuing austerity measures and tighter control of national expenses, especially on the member states facing financial stresses. See for example, Bellofiore, R. (2013) who perceives a way out of crisis requires not only monetary reforms and expansionary coordinated fiscal measures, but also a wholesale change of economic model built upon a new ‘engine’ of demand and growth that requires a monetary finance of ‘good’ deficits. Bellofiore, R. (2013). ‘Two or three things I know about her’: Europe in the global crisis and heterodox economics. *Cambridge Journal of Economics*.

the Eurozone in an effort to keep the EMU from breaking up. However, such sovereign bailouts are not only very expensive they are also highly unpopular with the citizens of lender countries.

The most important of forthcoming reforms is the decision to move towards a banking union reflected by the legislative proposal for a single supervisory mechanism (SSM) for the euro area, the entry into force of the European Stability Mechanism (ESM), and the ECB decision to undertake Outright Monetary Transactions (OMTs) in secondary markets for the bonds of Eurozone countries. Conditional on measures implemented at the national level, these policy initiatives will also support fiscal consolidation and private sector deleveraging.¹³¹ The Liikanen report¹³² has proposed solutions to separate deposit-taking banking from riskier banking activities. However, a comprehensive EU mandate on structural reform of the EU banking sector may take some time as the EU faces so many existential problems on numerous fronts.

Finally, irrespective of the progress already achieved on the policy side, the experience of the past two years reflects that reversal of sentiment in financial markets and widening of interest rate spreads can happen very rapidly if the implementation of radical measures falters or the measures do not seem radical enough to meet the requisite challenges. The next few paragraphs will provide an analytical account of the reforms that are developed to strengthen the EU's financial and monetary stability with particular focus on the forthcoming Single Supervisory Mechanism (SSM) and the mooted pan-European resolution and deposit insurance arrangements.

3. *The European Banking Union*

Responding to the ever growing pressure for more bank and sovereign bailouts the European Commission initiated the establishment of institutions that would support the ESM¹³³ and lead to

¹³¹ EU. (Autumn 2012). European Economic Forecast (Vol. European Economy: 7|2012). European Commission: Directorate-General for Economic and Financial Affairs, Retrieved from http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf.

¹³² Liikanen, E. (October 02, 2012). High-level Expert Group on reforming the structure of the EU banking sector. Brussels; available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

¹³³ See, Article 81 of the Regulation (EU) No 1093/2010; Regulation No 1094/2010; and Regulation (EU) No 1095/2010

the establishment of a more integrated banking union in the EMU.¹³⁴ This has, in principle, three pillars: a unified supervision mechanism (the SSM), operated by the European Central Bank, a future pan-European deposit guarantee scheme (DGS), and a future single bank resolution mechanism with common backstops.

It should be noted here that new structures adopted by the leadership of the Eurozone to put off the burning flames of the continuous banking and sovereign debt crisis are not without their detractors. Authoritative voices argue that European-level crisis management action (including bank recapitalizations by the ESM) which is so far contingent on the establishment of a permanent institutional infrastructure (i.e., an effective SSM) has been perceived as ‘a delaying tactic’ and in denial of the urgency of the present situation.¹³⁵ Another sensitive question pertains to whether the doors of a new integrated financial supervisory mechanism are to be closed on non-EU countries.

a. The Single Supervisory Mechanism (SSM)

As mentioned earlier, the EU’s reliance on national supervisory structures for the single market proved to be flawed. The failure of the rudimentary crisis management coordination mechanisms that were in place, through the Lamfalussy level 3 committees, lacked both the competence and the resources to cope with a cross-border banking crisis that endangered taxpayers’ money. Lack of appropriate co-ordination structures was nowhere more evident than bank recovery and resolution. Similarly the complete absence of a centralized EU structure dealing with systemic risk monitoring was incomprehensible. The most important of those gaps in the Eurozone institutional edifice is about to be remedied through the establishment of the first and most significant pillar of the proposed European Banking Union, the Single Supervisory Mechanism (SSM).

On 12 September 2012 the Commission proposed a single supervisory mechanism for Eurozone banks, which will be run by the European Central Bank (ECB), in order to strengthen

¹³⁴ See, speech of the President of the EU Commission Manuel Barroso, available at http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/06/20120626_speeches_2_en.htm

¹³⁵ Véron, N. (October 17, 2012). The First Step in Europe’s Banking Union: Difficult but Achievable. RealTime Economic Issues Watch; the Peterson Institute for International Economics. Available at <http://www.piie.com/blogs/realtime/?p=3174>.

the Economic and Monetary Union. The SSM is the first step towards an integrated ‘banking union’ which includes further components such as a single rulebook, common deposit protection and single bank resolution mechanisms. The Commission called on the Council and the European Parliament to adopt proposed regulations by the end of 2012, together with the other three components of an integrated ‘banking union’ – the single rulebook in the form of capital requirements (IP/11/915), harmonized deposit protection schemes (IP/10/918), and a single European recovery and resolution framework (IP/12/570). In the words of the president of the European Commission José-Manuel Barroso:

This new system, with the European Central Bank at the core and involving national supervisors, will restore confidence in the supervision of all banks in the euro area...We should make it a top priority to get the European supervisor in place by the start of next year. This will also pave the way for any decisions to use European backstops to recapitalize banks.

Barroso has also explained with authority the main purpose of these arrangements: ‘We want to break the vicious link between sovereigns and their banks. In future, bankers' losses should no longer become people's debt, bringing into doubt the financial stability of whole countries.’

The desirable ambit of the ECB’s supervisory powers has been the subject of considerable debate. Several member states have wanted the SSM to be restricted to ‘systemically important’ banks. For example, there is a controversy on whether German savings and cooperative banks should come under the remit of the SSM, as these banks consider themselves as local regional banks with passive assets and low risk exposures hence, subject to different policy regime from commercial banks. However, small or medium-size banks can also endanger the stability of EU financial system as well, e.g., the failures of banks like Northern Rock or the Spanish Caixas. Thus, a single supervisory mechanism is probably a more effective option. Furthermore, the existence of two supervisory mechanisms for banks, operating in the same market, would inevitably create conflicts of jurisdiction and competence (‘turf wars’) undermining the banking union. Early indications say that the ECB will be empowered to take over the supervision of any bank in the Eurozone if it so decides, in particular if the bank is receiving public support. Namely, the ECB will set the rules and be able to assume directly all

relevant supervisory tasks, whenever it considers it appropriate, for each one of these 6,000 Eurozone banks. However, in principle, the ECB will focus its direct supervision only on those banks, which can generate significant prudential risks through their size or risk profile.

Thus, within the unified supervisory system, the ECB have direct responsibility for around 150 banks with assets of more than 30 billion Euros, or those with assets representing more than 20 percent of a Member State's GDP. National supervisors within the same unified supervisory system will primarily supervise the remaining banks. Finally, while the ECB will have the power to step in to assume direct supervision at any moment, if need be, national supervisors will remain in charge of tasks like consumer protection, money laundering and branches of third country banks. ECB supervision will be phased in automatically on 1 July 2013 for the most significant European systemically important banks, and on 1 January 2014 for all other banks.

The ECB will be vested with the necessary investigatory and supervisory powers to perform its task and will apply single rulebook across the single financial market to carry out following functions:

- i. Licensing/authorizing credit institutions;
- ii. Monitoring compliance with capital, leverage and liquidity requirements;
- iii. Conducting supervision of financial conglomerates; and,
- iv. Early intervention measures (Prompt Corrective Action) when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action.

The reforms roadmap bequeaths ECB the status of a mother institution for the SSM. The June 2012 statement¹³⁶ identifies article 127(6) of the European Union's Lisbon Treaty¹³⁷ as the legal basis for the SSM, which means the new supervisor will be part of the ECB. Yet the roadmap does not hand over the management of the European Stability Mechanism (ESM) to the ECB until the new supervisory structures prove their effectiveness.

¹³⁶ Euro Area Summit Statement. (June 29, 2012). Brussels, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

¹³⁷ Treaty of Lisbon was signed on 13 December 2007 in Lisbon, entered into force on 1 December 2009. Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union. (30 March 2010). Official Journal of the European Union: C 83/01, Volume 53.

The legislative proposals¹³⁸ published by the Commission establishing the SSM have still to work out appropriate solutions for some outstanding issues. Firstly, as regards the geographical reach of the membership, that is, who to include and who to exclude from the EU members into the EBU. Beck has argued that the need for a banking union is stronger within a currency union because as it is here where the close link between monetary and financial stability plays out strongest and where the link between government and banking fragility is exacerbated as national governments lack policy tools that countries with an independent monetary policy have available.¹³⁹ But some non-euro area member states, including in Central Europe and Scandinavia, may want to join, and they have a veto over decisions under article 127(6). However, as far as the UK is concerned, it has been made categorically obvious that it would not join the SSM. Thus, while, the Commission maintains that the banking union and the single market are mutually reinforcing processes and that the establishment of banking union is inseparable from the completion of substantive regulatory reforms, which are already underway for the single market under the ‘single rulebook’, the geopolitical reality might be that the EMU and non-EMU members (Member States with a derogation) within the EU are pulling much further apart than ever before.¹⁴⁰

Secondly, there is a legitimate concern that adding supervision - a politically charged task - to the ECB’s responsibilities, may compromise its impartiality and independence. Therefore, the supervisory function needs to be kept discrete and independent from the rest of the ECB structures to preserve its institutional autonomy. This is a very important distinction since banking and monetary policy, though inter-linked, are not identical. However, there are contrasting views as regards the extent and form of separation between the two functions.¹⁴¹

¹³⁸ Issued on September 12, 2012, see EC. (September 12, 2012). Commission proposes new ECB powers for banking supervision as part of a banking union *Press Release*. Brussels/Strasbourg: European Commission. And also, Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union. (September 12, 2012) (Vol. COM(2012) 510 final). European Commission, available at http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510.

¹³⁹ Beck, T. (2012). Banking Union as a Crisis Management Tool, in Banking Union for Europe Risks and Challenges, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from http://www.dsfnl.nl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf

¹⁴⁰ Member States who have not adopted the euro are not members of the Governing Council of the ECB.

¹⁴¹ E.g., there is overlap of representatives between the supervisory board and the Governing Council. Therefore, as Beck and Gros conclude that raising Chinese walls between the two highly overlapping

b. The New EU Resolution Framework: Plans for Integrated Resolution Funds and Deposit Guarantee Schemes

To provide for common mechanisms to resolve banks and guarantee customer deposits, the Commission has proposed instituting a single resolution mechanism, which would govern the resolution of banks and coordinate in particular the application of ‘resolution tools’ to banks within the EU. The resolution mechanism is aimed at safeguarding the continuity of essential banking operations, to protect depositors, client assets and public funds, and to minimize risks to financial stability. This mechanism would be more efficient than a network of national resolution authorities particularly in the case of cross-border failures, given the need for speed and credibility in addressing the issues in the midst of a crisis.¹⁴² The decisions have to be taken in line with the principles of resolution as set out in the single rulebook consistent with international best practices and in full compliance with Union state aid rules, in particular that, shareholders and creditors should bear the cost of resolution before any external funding is granted.¹⁴³

The main resolution tools, as detailed in the Commission’s proposal directive for crisis management and resolution, are the following:

- (1) the sale of business tool whereby the authorities would sell all or part of the failing bank to another bank, without the consent of shareholders);
- (2) the bridge bank tool, which consists of identifying the good assets or essential functions of the bank and separates them into a new bank (bridge bank). The bridge bank will later be sold to another entity, in order to preserve these essential banking functions or facilitate the continuous access to deposits. The old bank with the bad or non-essential functions would then be liquidated under normal insolvency proceedings;

bodies would make no sense. See, Beck, T., & Gros, D. (March 2013). Monetary Policy and Banking Supervision: Coordination instead of Separation. *European Banking Center Discussion Paper No. 2013-003*; published as *CEPS Policy Brief*.

¹⁴² See also, Beck, T. (2012). *Banking Union for Europe Risks and Challenges*, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from http://www.dsfnl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf and Schinasi, G. (November 05, 2012) also distinguishes between immediate crisis resolution and intermediate to long-term measures.

¹⁴³ EC. (Sep 09, 2012). Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union (Vol. COM (2012) 510 final). Brussels.

(3) the asset separation tool, whereby the bad assets of the bank are put into an asset management vehicle. This tool relieves the balance sheet of a bank from bad or ‘toxic’ assets. In order to prevent this tool from being used solely as a state aid measure, the framework prescribes that it may be used only in conjunction with another tool (bridge bank, sale of business or write-down). This ensures that while the bank receives support, it also undergoes restructuring; and,

(4) the bail-in tool, whereby the bank would be recapitalized with shareholders wiped out or diluted, and creditors would have their claims reduced or converted to shares.

Therefore, an institution for which a private buyer cannot be found, or which cannot split up without destroying franchise value and other intra-firm synergies, could thus continue to provide essential services without the need for bail-out by public funds, and authorities would have time to reorganize it or wind down parts of its business in an orderly manner. To this end, banks would be required to have a minimum percentage of their total liabilities in the shape of instruments eligible for bail-in. If triggered, they would be written down in a pre-defined order in terms of seniority of claims in order for the institution to regain viability. The choice of tools will depend on the specific circumstances of each case and build on options laid out in the resolution plan prepared for the bank.

A bank would become subject to resolution when: (a) it has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, (b) all other intervention measures above have been exhausted, and (c) winding up the institution under normal insolvency proceedings would risk prolonged uncertainty or financial instability. Thus, entry into resolution will always occur at a point close to insolvency.

The Commission has also proposed the harmonization and simplification of protected deposit regimes, faster pay-outs and improved financing of schemes, notably through ex-ante funding of deposit guarantee schemes and a mandatory mutual borrowing facility between the national schemes. Therefore, if a national deposit guarantee scheme finds itself depleted, it can borrow from another national fund. The mutual borrowing facility would be the first step towards a pan-EU deposit guarantee scheme, and would be a natural complement to the establishment of a single supervisory mechanism. The single rulebook could include rules on the structure of the banking sector.

The EBA should develop a single supervisory handbook to complement the single rulebook. In order to avoid any divergence between the Euro Area and the rest of the EU, the single rulebook should be underpinned by uniform supervisory practices. Different supervisory handbooks and supervisory approaches between the Member States participating in the single supervisory mechanism and the other Member States pose a risk of fragmentation of the single market, as banks could exploit the differences to pursue regulatory arbitrage.

D. Evaluation of EU Regulatory Reforms

Weaknesses in the institutional framework have affected EU financial integration in two ways: firstly, the incomplete or partial harmonization of the pre-crisis supervisory and regulatory framework prevented the benefits of full integration from being reaped and created fragilities in the financial sector to build up in a way that became threatening over time and, secondly, the crisis revealed the vulnerabilities and gaps in the national and EU-wide crisis management frameworks. These weaknesses have resulted in partial disintegration of the internal market and have caused splits along national lines of some segments of the single EU market for capital and financial services.¹⁴⁴ Thus, for the EU, progression to a framework of tighter financial integration and risk controls for the banking system – together with improved governance standards in the monetary and fiscal spheres and centralization of responsibility for financial stability – has become a one-way road.

Current EU reforms promise to create a stronger financial and institutional framework in order to strengthen the resilience of the single market and mitigate the risk of vicious circles of market instability and fragmentation observed during the GFC and the on-going Eurozone debt crisis.¹⁴⁵ Nonetheless, current integration efforts are high risk, as their core only extends to the seventeen EMU members and, thus, it might create irreparable fractures for the internal market that remains incomplete at this stage.¹⁴⁶ Moreover, the new arrangements under the SSM need to

¹⁴⁴ ECB. (April 2012). Financial Integration in Europe: European Central Bank. P.87

¹⁴⁵ ECB. (April 2012). Financial Integration in Europe: European Central Bank. P.12

¹⁴⁶ Lastra, R. (2013). Banking Union and Single Market: Conflict or Companionship?, *Fordham International Law Journal*, Vol. 36, forthcoming.

become ‘first-best’¹⁴⁷ framework in order to stabilize the euro-area sovereign debt crisis and financial instability. Effective supervision, however, will challenge the fiscal sovereignty of Eurozone members,¹⁴⁸ especially, as the SSM will be able to activate the permanent EU rescue fund in order to directly recapitalize struggling Eurozone banks, such as those in Spain. This initiative, which essentially centralizes control over Eurozone finances by reducing the power of national governments, has attracted criticism from different quarters with respect to the role of the ECB, which will end up mustering an enormous amount of power without having a democratic mandate. At the same time, the legal basis for the new arrangements must be robust and must include a mechanism for judicial review, and gives rise to criticism as to whether this is best feasible under Article 127(6) of TFEU or other Treaty provisions.

Finally, the establishment of the SSM is only a big first step on a much longer path towards building crisis management and resolution institutions for the EU banking union. There remain several essential components such as a European banking charter, a fully-fledged single rulebook, a single resolution authority and a common deposit insurance scheme whose detailed arrangements are still to be worked out.

IV. Asian Financial Regionalism

A. Introduction

The reform of the EU integration mechanisms in the aftermath of the GFC and in the context of Eurozone debt crisis marks an important milestone in the integration process and regionalism drive, especially because it has exposed the failure of various institutional mechanisms supposed to ensure financial market stability. The EU crisis response bears significant implications in the development and functioning of single market operations and has emphasized the need to improve international and regional coordination on fiscal, monetary and financial policies affecting other states.

¹⁴⁷ Schinasi elaborates on ‘first-best’ mechanism in the EU context comprising of single supervisor, uniform deposit insurance, and European resolution mechanism.

¹⁴⁸ Schinasi, G. (November 05, 2012). European Banking Union: Pros and Cons - A View from Across the Atlantic. Power point presentation, Available at http://www.dsf.nl/assets/cms/File/Events/Garry%20Schinasi_European%20Banking%20Union%20.pdf.

Over a period of several decades, the progressive development of an integrated single financial market in the EU combined with a single currency among 17 of its members led to the imbalances that became visible when the GFC erupted in 2008.¹⁴⁹ Unfortunately, despite the vast amount of effort expended in developing both the EU single financial market and EMU, important design features necessary to support financial stability had not been put in place or were not sufficiently robust, particularly in relation to burden sharing, resolution of cross-border financial institutions, deposit guarantee arrangements, regulation and supervision, and fiscal arrangements and affairs.

Risks flowing from cross-border financial crises tend to intensify within integrated markets. The more integrated is a regional market the higher the propensity for cross-border contagion. The cascading effects of the on-going Eurozone crisis are a vivid reminder of the contagion risk in a highly integrated system.¹⁵⁰ The EU crisis is a powerful reassertion of the same reality that reflects on the vulnerability of economically integrated markets in times of crisis when national responses prove insufficient to deal with the common issues in an economically integrated area. The ‘new-normality’ that has surfaced in the context of the prolonged crisis in the EU, and the anaemic US recovery, appears to depend on even bigger contributions to economic stability and growth from Asia.

Building on the preceding review of Eurozone crisis and attendant reforms, this section explores regionalism in Asia in the context of issues relating to financial cooperation and integration. In this respect, Asian regionalism has been shaped by various market developments, external influences and various initiatives taken to respond to such common issues and to support stability of regional financial markets. From this basis, the paper analyses the implications for Asian regional financial arrangements from the financial integration-related issues that have arisen in the Eurozone crisis, including challenges to regionalism while highlighting potential opportunities to progress on regionalism in Asian context. This paper highlights the need for indigenous institutional infrastructure required to support integrated supra-national banking markets on the one hand, and the more transnational issues of financial liberalisation and free

¹⁴⁹ Stark, J. (2012). Crisis and Recovery in Emerging Europe: The Policy Response in Retrospect and Challenges Ahead. In T. Bracke & R. Martin (Eds.), *From Crisis to Recovery: Old and New Challenges in Emerging Europe* [electronic resource]: Palgrave Macmillan.

¹⁵⁰ ADB. (July 2012). *Asian Economic Integration Monitor: Asian Development Bank*. http://www.aric.adb.org/pdf/aeim/AEIM_2012July_FullReport.pdf.

movement of capital, financial services and trade on the other hand, in the context of ASEAN/ASEAN+3/+6 and ASEAN Community Strategy (Vision 2020).¹⁵¹

B. Asian Financial Regionalism: A Brief Overview

From the 1950s to the 1980s, individual economies in Asia adopted a range of models to support primarily domestic financial development. These ranged from Soviet style models of state ownership and control to liberal *laissez-faire*, with approaches to finance varying from model to model. By the end of the 1980s, the basic model in use was the Japanese model of ‘the developmental state with strong administrative direction of finance’ and this particular model proved the most successful in supporting balanced and inclusive economic growth and development in most of the East Asian economies. Gradually, this model tilted towards employing an export-led strategy to support economic growth while still maintaining a close relationship between government, business, and finance. Finance in this model largely originated through bank loans rather than equity markets.¹⁵² Contrasting with today, during this period, economic regionalism, generally, and financial regionalism more specifically, remained very limited and fragile. However, with the collapse of the Bretton Woods monetary system, the tremendous increase in cross-border capital flows and currency instability over the 1980s and 1990s led to the beginning of the formation of transactional regulatory international networks.

During the 1990s, in the context of the then-dominant Washington Consensus, East Asian economies focused on integration with the global economy (primarily the developed Western financial systems and markets) by following rapid liberal economic and financial policies in certain specific areas. Selective market liberalization without a backstop of appropriate legal and regulatory institutions set the stage for 1997-98 crisis that highlighted flaws in the combination of Japanese-inspired state-led model of development and selective liberalization. However, the reforms pursued after the Asian crisis marked the first beginning of significant economic and financial regionalism in East Asia, as economies started looking at ‘common interests’, which

¹⁵¹ To ensure economic growth and development across all the member states, ASEAN must ensure its regional centrality and ASEAN Economic Community is an important milestone to the bigger objective of seamless, borderless economic community by 2030. See, ADBI. (2012). ASEAN 2030: Toward a Borderless Economic Community (Draft Highlights). Japan: Asian Development Bank (ADB) Institute, available at <http://www.adbi.org/files/2012.03.30.proj.material.asean.2030.highlights.pdf>.

¹⁵² For discussion, see Liu, Q., Lejot, P., & Arner, D. A. (2013). *Finance in Asia: Institutions, Regulation and Policy* Taylor & Francis Ltd. Routledge. (forthcoming)

were not appropriately addressed under the prevalent international financial architecture.¹⁵³ The developments in the western world and the global financial and economic crisis which commenced in 2007 marked another turning point from the ‘export-led’ growth model as the decrease in demand for Asian exports, shifted regional consensus to support economic rebalancing both regionally and internationally.

In the East Asian context, a range of regional financial arrangements have been established, including, in particular, the Chiang Mai Initiative Multilateralisation (CMIM), the Executives’ Meeting of East Asia Pacific Central Banks (EMEAP) and aspects of ASEAN and ASEAN+3/+6. Since the prolonged global financial crisis have transformed into Eurozone debt crisis and a bland US recovery, growth rates and growth projections have slackened off for Asia as well, signaling for reforms required not only in western regulatory systems but also for regional markets in Asia.

C. Macroeconomic and Financial Cooperation in Asia

This section provides an overview of macroeconomic and financial cooperation in Asia and the regional institutional financial arrangements aimed at the development of common financial norms and standards. Despite the fact that in response to the Asian crisis in 1997-98 and 2008-09 GFC, East Asia has been progressing in respect of regional integration, yet these initiatives and institutional arrangements are at nascent stage of sophistication as compared to EU levels of development, because regional financial cooperation is constrained by national strategic rivalry and regulatory competition. The Asian reforms and regionalism initiatives focus only on increased rather than comprehensive and profound market integration; therefore, the possibility of regional monetary union in the near future is very unlikely, given the EU experiences on the one hand, and political differences in across East Asia, on the other.¹⁵⁴

However, despite the limitations, there are regional mechanisms at work. The ASEAN/+3/+6 Finance Ministers process plays a policy-setting role, including through the CMIM process (ASEAN+3 + Hong Kong).¹⁵⁵ Regional financial and monetary policy

¹⁵³ See, Arner, D. W., & Schou-Zibell, L. (2010 October). *Responding to the Global Financial and Economic Crisis: Meeting the Challenges in Asia*. Asian Development Bank working paper.

¹⁵⁴ See, for a detailed account of financial cooperation in Asia, Liu, Q., Lejot, P., & Arner, D. A. (2013)

¹⁵⁵ For an analysis of ASEAN Charter, see, Shimizu, K. (2011). The ASEAN Charter and the ASEAN Economic Community. *Econ. J. of Hokkaido Univ*, 73-87.

cooperation also takes place through Executives' Meeting of East Asia Pacific Central Banks (EMEAP) and the Bank for International Settlements' Asian Consultative Council (BIS ACC), with support from the BIS. Standards have largely been derived from the international process, but with increasing trend to develop regionally tailored equivalents through regional groups of international organizations, such as IOSCO. At the same time, there has been some movement to develop an Asian Financial Stability Dialogue (AFSD) to coordinate regional cooperation, coordination, and surveillance mandate. Implementation of international standards is widespread in the region, but willingness to participate in international monitoring through the IMF has traditionally been limited, albeit it is now increasing rapidly as a result of G20 commitments to Financial Sector Assessment Program (FSAP) participation. These arrangements may be sufficient for coordinative purposes; however, surveillance arguably requires a higher level of attention, with the CMIM having the potential to provide an appropriate framework, if effectively designed and implemented.

1. Developing regional financial markets

The currency and maturity mismatches and a heavy reliance on bank loans in East Asia, under the developmental state approach to finance, underpinned the crisis in 1997-98. The crisis provided not only the biggest impetus to later regional developments but also highlighted the depth of infrastructure-related gaps extant in the Asian financial markets.¹⁵⁶ Post-crisis attention paid to improve regional capital market development initially focused on the debt and money markets, but later, it began to consider wider securities market reform as well.¹⁵⁷ The reform on debt market development has mainly focused on the ASEAN+3 ABMI.¹⁵⁸

ASEAN+3 launched Asian Bond Markets Initiative (ABMI) in 2003, to help promote domestic reforms aimed at expanding the size of national and regional bond markets, to attract regional and foreign investors, and strengthen the bond market infrastructure related needs.

¹⁵⁶ See for a discussion on the logic of Asian integration efforts after 1997/98 crisis and challenges to further integration, Kawai, M. (2004). Regional Economic Integration and Cooperation in East Asia. *Seminar paper on "Impact and Coherence of OECD Country Policies on Asian Developing Economies," Policy Research Institute of the Japanese Ministry of Finance and the OECD, June 10-11; <http://www.oecd.org/pcd/33628756.pdf>*

¹⁵⁷ ASEAN+3 is studying cooperation among exchanges and regulators to encourage cross-border trading.

¹⁵⁸ Thailand initiated the ACD in 2002 among ASEAN+3, India, and fourteen other central Asian states to explore regional cooperation to encourage capital market activity. The group's visibility fell after the end of Thailand's APEC chairmanship in 2004.

Another motive behind ABMI was also to help divert savings to local and regional investments. In this regard, the Asian Bond Fund (ABF), supported by EMEAP, promoted the development of national and regional bond markets by directly creating bond funds. The first such Fund, ABF1 was launched in 2003. The ABF completed Phase 2 of the eight ABF2 single market funds in May 2011.¹⁵⁹ Another initiative, the Roadmap+, was adopted in order to produce tangible and concrete outcomes going forward with the support from the ADB, and to reinvigorate the ABMI discussions.¹⁶⁰ The Roadmap+ identified nine priorities which include: (i) launching guarantee programs under the Credit Guarantee and Investment Facility (CGIF); (ii) developing infrastructure-financing schemes (including a pilot project involving the Lao PDR and Thailand); (iii) fostering an investment-friendly environment for institutional investors and sharing ABMI expertise with them; (iv) enhancing ASEAN+3 Bond Market Forum (ABMF) activities (including the Common Bond Issuance Program); (v) facilitating the establishment of the Regional Settlement Intermediary (RSI); (vi) further developing government bond markets; (vii) enhancing financial access to consumers and small and medium-sized enterprises (SMEs); (viii) strengthening the foundation for a regional credit rating system; and (ix) raising financial awareness.¹⁶¹ While these initiatives and structures are aimed at intensifying efforts to build integrated financial markets under the ASEAN umbrella, yet the expectations from the lead regional economies - the PRC, Japan, and the Republic of Korea - demand active cross-market role to propagate effective and resilient regional integration mechanisms.

2. Trade in financial services

Asia is leading growth in global trade through intraregional and recently amplified 'South-South' trade in contrast to its traditional export markets used to primarily concentrate in the US and Europe. Despite the rise in trade related integration, financial integration lags behind trade and investment in East Asia. Given various ASEAN/+3/+6 agreements aimed at trade enhancement are implemented, it is likely that aspects relating to financial services trade will receive increasing attention. Cross-border trade flows, direct investment, and cross-border investment in

¹⁵⁹ The PRC; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; and Thailand.

¹⁶⁰ ADB. (July 2012)

¹⁶¹ AFMGM+3. (May 03, 2012). The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting Manila, the Philippines.: ASEAN+3, <http://english.mosf.go.kr/pre/view.do?bcd=N0001&seq=2939>.

capital goods have long been greater and faster growing than other regional capital flows. Formal economic integration is a relatively new initiative in East Asia. Amongst the most recent is the launch of the ASEAN Regional Comprehensive Economic Partnership (RCEP) to create a free trade area with comprehensive economic cooperation.

Prior to RCEP's introduction, region-wide agreements were known as ASEAN-China Free Trade Agreement (ACFTA), involving ASEAN+3 partners, and Comprehensive Economic Partnership for East Asia (CEPEA), which is a Japanese led proposal for trade co-operation, and includes ASEAN+3 and India, Australia, and New Zealand. According to some estimates, the benefits from RCEP will much exceed the benefits from the formation of the ASEAN AEC. Also, such an arrangement has a potential to reduce the complexity of the current situation, which is known as 'the noodle bowl syndrome' - partly the result of a lack of vision toward East Asian economic integration. Currently there are five FTAs/EPAs between ASEAN and its partners. Some of them are also complemented by bilateral agreements between individual ASEAN members and their partners.¹⁶²

3. Economic Review and Policy Dialogue

The ASEAN+3 Economic Review and Policy Dialogue is the most important mechanism for information exchange on economic conditions and policies in Asia. The ASEAN Surveillance Process was established in 1998, to monitor macroeconomic and financial vulnerabilities and strengthen policy dialogue through peer review.¹⁶³ In May 2000, ASEAN+3 finance ministers launched the Economic Review & Policy Dialogue (ERPD) Process. The ERPD also played a vital role in formulation of the regional liquidity support facility i.e., the Chiang Mai Initiative (CMI). The ASEAN+3 Macroeconomic Research Office (AMRO), was also an important step in institutionalizing the ERPD and a multilateralized version of the CMI, or CMIM. The important prescription that follows from current European crisis is that the regional surveillance must complement global surveillance, which is being conducted mainly by the International Monetary

¹⁶² Damuri, Y. R. (November 16, 2012). East Asia economic integration and ASEAN centrality, The Jakarta Post. Retrieved from <http://www.thejakartapost.com/news/2012/11/16/east-asia-economic-integration-and-asean-centrality.html>

¹⁶³ See for discussion on these mechanisms, ADB. (2008). Emerging Asian regionalism: A partnership for shared prosperity. Manila: available at http://aric.adb.org/emergingasianregionalism/pdfs/Final_ear_chapters/final%20report.pdf

Fund (IMF) and other multilateral organizations to provide comprehensive contagion-risk coverage.¹⁶⁴

4. Regional financial safety nets

The CMIM is the premier regional financial safety net for providing liquidity support to ASEAN+3 countries. The CMI was created with the purpose to “provide sufficient and timely financial support to ensure financial stability” in Asian region,¹⁶⁵ and to supplement existing international facilities, primarily performed by the IMF internationally. CMI has been growing and expanding on its inception goals, and was multilateralized to become a collectively managed reserve-pooling arrangement (CMIM) governed by a single contract in 2010¹⁶⁶ with US\$120 billion in commitments.¹⁶⁷ At inception, 20 percent of the aggregate amount was to be available for drawing under CMIM by a user state, “de-linked” from specific IMF conditionality, but subject to rules to be developed by ASEAN+3 members.¹⁶⁸ However, the arrangement was conceived as to “supplement the existing international financial arrangement.”¹⁶⁹ This enhancement of the role was visualized in May 2012, when ASEAN+3 included and improved upon crisis resolution mechanism and a crisis prevention facility - CMIM Precautionary Line (CMIM-PL) - to further support the CMIM given the high degree of contagion-risks.¹⁷⁰ An AMF was also mooted during the 1997-98 financial crisis when several Asian states required sudden infusions of credit but the plan was abandoned upon intense US opposition.¹⁷¹

¹⁶⁴ ADB. (2009). Regional Surveillance for Economic Stability. Asia Economic Monitor. Available at http://aric.adb.org/pdf/aem/dec09/Dec_AEM_special.pdf;
http://aric.adb.org/pdf/aem/dec09/Dec_AEM_complete.pdf.

¹⁶⁵ See, ASEAN+3. (May 2000). ASEAN+3. Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting: May 06: available at http://www.mof.go.jp/english/international_policy/convention/asean_plus_3/if014.htm.

¹⁶⁶ ASEAN. 2012. *Joint Media Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting*. 3 May.

¹⁶⁷ See, ASEAN+3. (February 2009). Report from the Finance Ministers of the ASEAN+3 to Heads of States/Governments, and, ASEAN+3. (May 04, 2008). Joint Ministerial Statement of the 11th ASEAN+3 Ministers Meeting.

¹⁶⁸ ASEAN+3 (May 2000).

¹⁶⁹ Ibid.

¹⁷⁰ I. Azis. 2012. Asian Regional Financial Safety Nets? Don't Hold Your Breath. *Public Policy Review*. 8 (1).

¹⁷¹ A regional monetary fund was discussed again within ASEAN+3 in April 2006 in terms of benefits associated with a long-term currency alliance and monetary union.

5. Renminbi internationalization and regionalization

Apart from encouraging cross-border investments in each other's government bond market, the PRC, Japan and the Republic of Korea in December 2011, agreed to promote the use of local currencies in cross border transactions. The PRC has been promoting the international use of the renminbi as a regional invoicing currency.¹⁷² The renminbi's potential as eventual reserve currency could help the PRC shield its domestic economy from US dollar volatility. While this move from the PRC bears deep and extensive implications for both regional and global economic cooperation and integration, it demands several pre-conditions to meet before Renminbi can enjoy the status of a reserve currency in parallel to the US dollar, and financial liberalization would be only one such requisite. Therefore, the goal to have Renminbi as a regional anchor currency to be followed by an international reserve currency requires open markets and institutional support infrastructures, accompanied by harmonization of standards, improved legal norms, better creditor rights amongst other prerequisites as seen from EU experience.¹⁷³

D. The Asian Regional Financial Architecture: Implications for Existing Institutional Arrangements (CMIM, ASEAN/+3, EMEAP, AEC)

This section discusses existing and on-going East Asian regional institutional arrangements, focusing on CMIM, ASEAN/ASEAN+3, EMEAP and AEC, and the possible implications of the Eurozone experience on existing structures. Although, the nature of the financial markets call for presence of much needed global regulator but because of the difficulties involved in crystalizing a global mechanism under the existing circumstances, regional institutions still can form a global framework instead to mandate minimum consistency across jurisdictions in regulatory principles applicable to similar markets, institutions, services, and products.

East Asia, in seeking to further develop regional financial and economic markets, must take into account the debates on sovereignty trade-offs and economic stability, and jurisdictional risk trade-offs to ensure continuity and development of an integrated market. It has had its share of experience of 'contagion-driven' risks in 1997-98 when the level of Asian cross-border

¹⁷² In August 2010, HKMA allowed all authorized institutions to take part in the interbank bond market using Renminbi through a settlement agent and after seeking PBOC's approval. Hong Kong, China, Singapore, and London all have some international trade settled in Renminbi - with Hong Kong, China taking the lead. In early July 2012, the Singapore Exchange announced that it is ready to list, quote, trade, clear and settle securities denominated in Renminbi.

¹⁷³ ADB. (July 2012).

financial holdings and market integration was far less than what it is now. Therefore, integration - that brings many advantages - nonetheless has its own down-side effects as well.

One important lesson that transcends from past is that these frameworks must be sensitive to domestic peculiarities of especially less developed and smaller regional economies. Given the new international regulatory requirements on capital, liquidity and leverage ratios, meeting those higher standards could be challenging, for smaller states therefore, the development of regional arrangements such as the establishment of a high-level Asian Financial Stability Dialogue (AFSD) would provide special support to such smaller economies in the region. One such mistake was done during the EU single market developmental phase by meandering around the eligibility criteria for member states through manipulation of economic data by the states in order to win eligibility to join the club. Therefore, any reform in Asia including the one being contemplated by ASEAN Economic Community to establish a 'banking Union' where states need to meet specific criterion before joining the 'club' must be structured with the lessons learnt from European experience in mind. Requisite institutional reforms must simultaneously be pursued at the national, regional and international level and focus on the following developmental requirements: (i) the need to balance regulation and innovation, (ii) establishment of national and cross-border crisis management and resolution mechanisms, (iii) preparation of a comprehensive framework and contingency plans for financial institution failure, including consumer protection measures such as deposit insurance, (iv) supporting growth and development with particular attention to the region's financial needs for infrastructure and for SMEs, and (v) reforming the international and regional financial architecture.¹⁷⁴

1. The Chiang Mai Initiative's Multilateralisation (CMIM)

The CMIM provides the outline of a potential crisis management structure and of a potentially important liquidity mechanism for the region. However, even under the CMIM, crisis resolution at the sovereign level - as in the 1997-98 Asian financial crisis - remained with the IMF because the major donor countries in Asia (the PRC, Korea and Japan) were reluctant to assume full responsibility of a bail out. Therefore, the CMIM and current ASEAN+3 are marked by conflicting priorities. To respond to the 199-/98 crisis, there were neither regional arrangements

¹⁷⁴ Arner, D. W., & Park, C. Y. (2010). Global Financial Regulatory Reforms: Implications for Developing Asia. *Working Paper Series on Regional Economic Integration*, 57, 48-48.

available to deal with the resolution of individual financial intermediaries (including in most cases at the domestic level),¹⁷⁵ nor for addressing the contagion impact of systemic loss of confidence that affected the region. However, the proposals to transform CMIM into a regional fund picked up pace as most of the Asian economies were dissatisfied with the liquidity support role played by the IMF in the 1997-98 crisis. Now, if CMIM were to evolve into an AMF, it would seem logical to combine liquidity provision and macroeconomic standard-setting and monitoring with more formalized arrangements for regional financial regulatory standards. Institutional developments of this kind also provide an opportunity to consider proper organization of the functions outlined here, whether or not formalized into a new AMF, including purposes, extent of non-Asian involvement, if any, conditions for usage, and whether any single state will lead the initiative.

2. ASEAN/ASEAN+3/+6

ASEAN is presently the main regional arrangement addressing financial services liberalisation. At present, ASEAN is at a much more elementary stage of development than the EU. The hindrances to full financial service liberalization primarily revolve around the trade-offs attached to relinquishment of national policy controls, which is in accord Asian ethos and political traditions.¹⁷⁶ Weaker regional institutions and the slower pace of integration are only a natural manifestation of these shared norms extant across region, which are in line with the consensual ‘ASEAN way’. The organization of Asian capitalism on the basis of the developmental state model has been effective in Japan, Korea, and the PRC. It is characterized by close directional relationships between state and leading commercial interests.¹⁷⁷ However, the Eurozone financial crisis highlights the necessity of having in place very clear ex ante arrangements for dealing with cross-border financial institution failures which calls for a greater role of ASEAN.¹⁷⁸

Over the years, ASEAN and its East Asian partners, the PRC, Japan and the Republic of Korea—ASEAN+3—have cooperated on three broad areas of macroeconomic and financial policies: (i) economic review and policy dialogue, (ii) regional financial safety nets, and (iii)

¹⁷⁵ see Arner and Norton (2009).

¹⁷⁶ This has clearly been manifested in the primacy of accumulation of international reserves in the region during the first decade of 21st century when national exchange rate policies ran supreme over any regional market development initiatives.

¹⁷⁷ See, Redding, G. (1990). *The Spirit of Chinese Capitalism*: Walter de Gruyter.

¹⁷⁸ Arner, D. W., & Schou-Zibell, L. (2010 October).

regional financial markets. These initiatives have been further strengthened in the aftermath of the GFC.¹⁷⁹ The integration scale, however, has been far higher for trade in goods than in financial services. ASEAN's 1995 Framework Agreement on Services (AFAS)¹⁸⁰ sought to reduce barriers to trade in services. Back in 2006, ASEAN and Australia's official Regional Economic Policy Support Facility commissioned an assessment study that concluded that its performance was both disappointing and unimpressive.¹⁸¹ Presently, in the ASEAN+3 treaties, this area carries greater potential to support further regional financial integration. ASEAN+3 along with WTO and ASEAN+6¹⁸² have also replaced APEC's role in governance and resources (which was thought to be an effective forum for economic concerns prior to the 1997/98 crisis).¹⁸³ In the context of ASEAN / ASEAN+3, rather than a single supervisor, this is much more likely to focus on separately regulated and capitalised subsidiaries in each jurisdiction of operations (albeit to increasingly common standards based on international guidelines).

APEC retains advantages over competing regional structures but it needs to seek reforms to accelerate the Bogor Goals¹⁸⁴ and enhance APEC's institution-building and monitoring system while ensuring its complementarity with other regional organizations including the WTO. APEC's goal of creating a Free Trade Area of the Asia-Pacific (FTAAP) can overcome structural limitations and serve as an effective 'Plan B' for the Doha Round standoff. Nonetheless, caution should be taken for legal challenges on the road to an FTAAP such as the Trans-Pacific Partnership. Such reforms will strengthen APEC's role under the multilateral trading system and reenergize the public-private partnership for trans-Pacific integration.¹⁸⁵ Trade in goods is being addressed to date through ASEAN/+3/+6 treaty-based arrangements; however, based on the

¹⁷⁹ ADB. (July 2012). P.48

¹⁸⁰ ASEAN. (Dec 15, 1995). Framework Agreement on Services: available at <http://cil.nus.edu.sg/rp/pdf/1995%20ASEAN%20Framework%20Agreement%20on%20Services-pdf.pdf>. See also, ASEAN. (Sep 02, 2003). Protocol to Amend the ASEAN Financial Services Agreement

¹⁸¹ Thanh, V. T., & Bartlett, P. (2006). Ten Years of ASEAN Framework Agreement on Services (AFAS): An Assessment., *REPSF Project No. 05/004*; available at http://www.aadcp2.org/uploads/user/6/PDF/REPSF/REPSF_05_004_FinalReport.pdf.

¹⁸² Includes India, Australia, and New Zealand

¹⁸³ Hsieh, P. L. (2013). Reassessing APEC's role as a Trans-Regional Economic Architecture: Legal and Policy Dimensions. *Journal of International Economic Law*, 16(1), 119-158.

¹⁸⁴ APEC. (November 15, 1994). Leaders' Declaration - Economic Leaders' Declaration of Common Resolve: Bogor, Indonesia, available at http://www.apec.org/Meeting-Papers/Leaders-Declarations/1994/~/_media/Files/LeadersDeclarations/1994/1994_LeadersDeclaration.ashx.

¹⁸⁵ Hsieh, P. L. (2013)

WTO experience, as these develop, it is likely that a more effective dispute resolution framework may become necessary at some point. As shown by the EU crisis, the relationship between liberalization and stability is much more critical in the case of the financial services industry, while liberalization may proceed, especially as regional and global financial institutions seek greater market access, it would appear best for economies for the foreseeable future to adopt arrangements for cross-border provision on the basis of separately capitalized and regulated subsidiaries, rather than following the passport system which has been adopted by the EU.

3. Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)

EMEAP was established in 1991 to provide the main mechanism for central bank, regulatory and financial infrastructure cooperation in the region among the more developed financial jurisdictions. Other similar organizations in Asia include: South East Asia, New Zealand, Australia (SEANZA), the South East Asian Central Banks (SEACEN) Research and Training Centre, and the BIS (which is also playing a supporting role for EMEAP and regional central bank cooperation since 1990's). EMEAP now co-organizes meetings with the European Central Bank (EMEAP–Euro system High Level Seminars) to increase communication and deepen relations between EMEAP and the Euro system since 2004. EMEAP plays a significant role in central bank coordination and cooperation amongst its membership, and works closely with ASEAN/+3/+6, ADB, BIS (especially the BIS ACC and Asian Office), and international standard setters. As a result of shared crisis experiences, the effectiveness and impact of the group has grown, with regional initiatives such as the ABF and support for CMIM.¹⁸⁶

4. ASEAN Community and ASEAN Economic Community (AEC)

The ASEAN Vision 2020, first adopted by the ASEAN Heads of State/Government in the Kuala Lumpur summit in December 1997, was made more concrete in January 2007 when ASEAN Heads of State/Government signed the Cebu Declaration¹⁸⁷ on the Acceleration of the

¹⁸⁶ Arner, D. W., & Schou-Zibell, L. (2010 October)

¹⁸⁷ For the Cebu declaration, see, <http://www.asean.org/component/zoo/item/about-asean-overview-cebu-declaration-on-the-acceleration-of-the-establishment-of-an-asean-community-by-2015?Itemid=185>

Establishment of an ASEAN Community¹⁸⁸ by 2015. The ASEAN Economic Community (AEC) shall be the goal of regional economic integration by 2015. AEC envisages the following key characteristics: (a) a single market and production base, (b) a highly competitive economic region, (c) a region of equitable economic development, and (d) a region fully integrated into the global economy. Under the AEC roadmap, the monetary and financial integration is broadly structured around three themes: (i) harmonizing regulations, market standards, and rules; (ii) developing market infrastructure and regionally focused products and intermediaries; and (iii) strengthening member countries' capacities.¹⁸⁹ At their 16th meeting in Cambodia in April 2012, ASEAN finance ministers reaffirmed their commitment.¹⁹⁰ However, there is a gap between declarations and the actual implementation of those pronouncements. The implementation rate of AEC Blueprint¹⁹¹ has recently increased to 74.5 percent.¹⁹² In the declaration, the domestic difficulties in implementation of AEC were also recognized, but ASEAN finance ministers agreed to intensify efforts in those areas under the AEC in order to achieve AEC goals by 2015.¹⁹³

The ASEAN Banking Integration Framework (ABIF) sets timelines for Pan-ASEAN banking strategy to be adopted in two stages. The first stage will focus on pan-ASEAN banking through separately capitalised subsidiaries. This will initially be done through the developed

¹⁸⁸ The ASEAN Community comprised of three pillars: the ASEAN Political-Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community. Each pillar has its own Blueprint, and, together with the Initiative for ASEAN Integration (IAI) Strategic Framework and IAI Work Plan Phase II (2009-2015), they form the Roadmap for and ASEAN Community 2009-2015.

¹⁸⁹ ASEAN. (2009). Roadmap for an ASEAN Community; ASEAN. (2009). Implementing the Roadmap for an ASEAN Community 2015.

¹⁹⁰ ASEAN. (November 20, 2012). Declaration on the East Asia Summit Development Initiative. Phnom Penh, Cambodia. Available at <http://asean2012.mfa.gov.kh/?page=detail&menu1=0&menu2=342&article=342&lg=en>

¹⁹¹ ASEAN Economic Blueprint was signed at the 13th ASEAN Summit, on 20 November 2007 in Singapore, to guide the establishment of the ASEAN Economic Community 2015. See also, ADBI. (2012), and ASEAN. (2009). ASEAN Economic Community (AEC) Blueprint *Roadmap for an ASEAN Community 2009-2015* (pp. 21-67).

¹⁹² Pushpanathan, S. (April 07, 2010, Wednesday). No place for passive regionalism in ASEAN, The Jakarta Post. Retrieved from <http://www.thejakartapost.com/news/2010/04/07/no-place-passive-regionalism-asean.html>

¹⁹³ See, ASEAN. (November 18, 2012). 'One Community, One Destiny', Chairman's Statement of the 21st ASEAN Summit. Phnom Penh. last visited, March 12, 2013, Available at <http://asean2012.mfa.gov.kh/?page=detail&menu1=0&menu2=343&article=343&lg=en>

members, with the developing members following at a later stage.¹⁹⁴ Such platforms necessitate regulatory convergence across jurisdictions. However, the Framework may be applicable to both ASEAN banks and non-ASEAN banks meeting the requirements. The idea is to have ‘Qualified ASEAN Banks’ (QABs), with regulatory harmonisation across ASEAN (once again, with the five developed countries going first, followed later by the developing members). Asian authorities have agreed upon four preconditions to ensure the banking integration framework is successfully implemented. The first is harmonization of regulations; second, building financial stability infrastructure; third, assisting the BCLMV countries to build their banking capacity, and fourth establishment of set criteria for ASEAN qualified banks to operate in any ASEAN country with a single ‘passport’. ABIF’s concept of integration is restricted to the commercial presence of qualified banks. Thus, it takes such presence as the benchmark for ASEAN banking integration by 2020. This is highly debatable because it will not necessarily reflect the success of ABIF in bringing about economic benefits and financial stability to the region.¹⁹⁵ The second stage will allow branching, based on harmonisation and QABs which will require addressing issues such as supervision, resolution and deposit insurance. This resembles closely to the patterns that are being adopted at the EU level where banks would not be under the control and supervision of member state’s domestic laws rather the authority would be transferred to the ECB.

E. Challenges to Regionalism: The Way Forward

In the context of furthering financial integration, the EU provides the leading example and simultaneously highlights very real difficulties for other regions, including Asia. As enhanced financial integration brings increased risk of contagion in the event of a crisis, regional cooperation is even more important for developing post-crisis resolution mechanisms. As the uncertainty of world financial conditions and heightened possibility of a contagion-driven crisis persistently looms over global financial markets, it only makes sense for Asian countries to have

¹⁹⁴ A double-track implementation plan has been adopted for the developed ASEAN 5 (Singapore, Malaysia, Thailand, the Philippines and Indonesia), and the developing, BCLMV countries (Brunei Darussalam, Cambodia, Laos, Myanmar and Vietnam).

¹⁹⁵ Siswanto, J., & Wihardja, M. M. (May 31, 2012). ASEAN banking integration: positioning Indonesia. East Asia Forum: Economics, Politics and Public Policy in East Asia and the Pacific. <http://www.eastasiaforum.org/2012/05/31/asean-banking-integration-positioning-indonesia/>

their own regional safety nets strengthened in order to prevent a cross-border financial stability crisis triggered by exogenous factors.

Seven building blocs ought to be present in any system of financial regulation in order to address systemic risk:

- (i) robust financial infrastructure, especially payment and settlement systems;
- (ii) well-managed financial institutions with effective corporate governance and risk management systems;
- (iii) disclosure requirements sufficient to support market discipline;
- (iv) regulatory systems designed to reinforce risk management and market discipline, as well as setting and monitoring potential risks across all financial institutions;
- (v) a lender of last resort institution/facility to provide liquidity to financial institutions on an appropriate basis, in the event of liquidity shocks;
- (vi) a resolution scheme for problem institutions; and
- (vii) appropriate rules and procedures to protect financial services consumers, such as deposit insurance.

The global financial crisis has highlighted significant weaknesses in each of these parts of financial regulation design, which are currently being addressed by the G20.

In Asia, the global financial crisis highlights the necessity of addressing a range of issues relating to financial integration and regionalism, which, in a sense, go much beyond the financial stability challenges raised by the global financial crisis. First, there is a pressing to continue with the development of Asian regional alternatives to address issues relating to liquidity, liberalization, regulation, capital controls and exchange rate volatility. Before the advent of the GFC, financial innovation was regarded as inextricably linked with economic growth and aggregate welfare however, in the wake of the crisis the utility of financial innovation has become more unequivocal. In addition, regional macroeconomic and financial surveillance mechanisms also have clear value, as demonstrated both by the 1997-98 Asian financial crisis and the more recent global financial crisis, especially in the context of the euro area. The main challenge in terms of capital provision, however, is underdeveloped domestic and regional capital markets. As economies across the region grow and banks increase lending, there will be consequent requirements to increase capital. As a result, the availability of well-developed equity and debt capital markets to support bank capital will become an increasingly major concern.

Secondly, in addition to domestic and regional considerations, the crisis implies an enhanced role for the Asian economies within global regulatory and supervisory institutions, such as the IMF and Financial Stability Board (FSB). The IMF, G-20, and the FSB are pursuing structural reforms to allow wider representation of the Asian economies and tend to pay increased attention to Asian leaders' recommendation with respect to redesigning the global regulatory architecture.

Increasing Asian influence is grounded in (a) the relative success of more conservative Asian approaches to liberalization, and policy implementation, and (b) from the parallel decline of the contribution from the west in economic growth indicators vis-à-vis Asian countries. While there is a visible shift of focus from the western models towards Asian markets, this remains a fact that Asian financial markets are still evolving and, therefore, provide ample scope for newer developments. Asian financial outlook is susceptible to four significant factors that may grow into bigger threats. These include: over-heated economies and excessive reliance on export-led growth models; faulty reserve-accumulation models; narrow export market limited to western vendors only; and weaknesses in institutional mechanisms and legal backstops to carry out financial regulation and supervision. Therefore, to address shocks emanating from the Eurozone crisis, Asian countries need to work on a dual objective. First, to cultivate new domestic and regional sources of growth and second to foster markets in the less developed countries of the region, where financial sector development is a critical factor.

Another challenge facing Asian countries is finding ways to formulate structures that will allow them to speak with a common voice in the international regulatory landscape, in order to balance the US and EU influence in this sphere. In this context, ASEAN+3 and ASEAN+6 could, with requisite modifications, provide a suitable mechanism, with the AFSD playing a similar role in the context of the FSB. This crisis has also brought back to light questions regarding international currency arrangements, which have largely been abandoned since the 1970s when the Bretton Woods system of fixed exchange rates collapsed. In this context, proposals have been put forward by the Stiglitz Commission and the PRC which begin with the premise that, as demonstrated by the current global financial crisis, the risks of the current system of floating exchange rates exceed its benefits and fail in the overall objective of supporting trade and enhancing economic growth and financial stability.¹⁹⁶ In place of the

¹⁹⁶ Arner, D. W., & Schou-Zibell, L. (2010 October)

current system, both propose a new system based on an international reserve currency disconnected from individual nations able to remain stable. The eye-catching agreement in 2006 in respect of Asian Currency Unit (ACU), which might be a first step on the long road to an ‘Asian Euro’, reflected that Asian leaders were willing to enhance financial cooperation.¹⁹⁷ This however, is a long-term vision, requiring a long-term process with step-wise milestones to meet.

Moreover, it is not controversial, even though it does challenge orthodox thinking, to argue that financial integration is not always beneficial. Despite the increased importance of enhanced regionalism and integration, policy formulation must take a balanced view. The European crisis provides a deep insight to the risks of integration and identifies mistakes not to be repeated in following integration plans elsewhere. For example, for the banking integration framework (ABIF), in the short term, it should deliver its promise to facilitate economies of scale, a bigger market, technological transfer and information sharing i.e., ‘the soft-infrastructure’ but in the long term, it should aim for financial stability through consolidated integration i.e., the ‘hard infrastructure’.¹⁹⁸

This balanced view of integration offers further perspectives: Firstly, that the soundness and credibility of domestic policies are not substitutes for regional commitments even though, at times when domestic policies are ‘stuck’, regional commitments can help to ‘tie hands’ and exert external pressure. Secondly, rather than imposition of strict benchmarks and milestones to meet the idiosyncrasies of individual economies, the integration framework should facilitate and encourage the growth of regional economies while allowing the market to work freely. Thirdly, it doesn’t matter how much integration or liberalization has been achieved in the region, but what matters is that regional approaches and small steps of cooperation will result in the Asia being more integrated and on the path to a reduced dependence on western markets which can bring more growth, development and stability to the region while lowering associated contagion-driven risks.

¹⁹⁷ Sohn, I. (2006). East Asia’s Counterweight Strategy: Asian Financial Cooperation and Evolving International Monetary Order. United Nations Conference on Trade and Development & Group of Twenty-four; United Nations, New York, <http://dspace.cigilibrary.org/jspui/bitstream/123456789/13408/1/East%20Asias%20Counterweight%20Strategy%20Asian%20Financial%20Cooperation%20and%20Evolving%20International%20Monetary%20Order.pdf?1>.

¹⁹⁸ Siswanto, J., & Wihardja, M. M. (May 31, 2012)

V. Implications for East Asia

Owing to substantively divergent levels of development, institutional and legal structures, and political systems, East Asian economies lag behind European and North American economies in financial integration. At the same time, both trade and investment flows in the region have grown very rapidly over the past 20 years. The Asian financial crisis in late 1990s provided an impetus for more financial integration within the region. One group of scholars perceive differences between EU and East Asian financial integration as a matter of degree and not of nature.¹⁹⁹ According to this school of thought, regulatory convergence takes time; whereas, the quality and sustainability of convergence is the key to the success of the whole process itself.²⁰⁰ Given this context, the European example constitutes a major significant precedent and as a laboratory of economic, legal, and political integration transcending national borders.

The Eurozone debt crisis has clearly exposed the weaknesses of regulatory structures divided along national lines when these have to deal with integrated cross-border financial markets. It has also highlighted the limited range of policy choices available from within the EU / EMU system as it existed prior to 2008. As a result, the EU faces a number of hard choices extending to the intractable trade off between national sovereignty and collective financial stability. The plans to establish a European banking union within the boundaries of the Eurozone, which will include a single supervisor and, in the future, a single resolution authority and a pan-European deposit guarantee scheme, have clearly tilted the balance towards further centralization and pooling of sovereignty.

From the EU regulatory reforms discussed above, three initiatives stand out. First, plans to centralize supervision for Eurozone banks through the SSM, which will come into force in 2014. This will mean that the ECB²⁰¹ is poised to take over as the prudential supervisor of the Eurozone banking sector. Second, EU plans for the harmonization of member state resolution laws and introduction of integrated resolution structures are in the process of implementation.

¹⁹⁹ Wouters, J., & Ramopoulos, T. (2012)

²⁰⁰ Smaghi, L. B. (2012). Convergence in Central and Eastern Europe: Lessons and Non-lessons from the Crisis. In T. Bracke & R. Martin (Eds.), *From Crisis to Recovery: Old and New Challenges in Emerging Europe* [electronic resource] Retrieved from <http://dx.doi.org/10.1057/9781137034830> Palgrave Macmillan. P.26

²⁰¹ It should also be noted that the ECB had never had a 'treaty-based' mandate to act as shock-absorber in the Euro area sovereign debt markets. Absence of this mandate will continue to represent a missing link in the EU reform process.

Third, the development of common EU rulebooks for the single market by the European Supervisory Authorities is proceeding rapidly. Another area of particular importance is the adoption by the EU, through the ESM (and the European Banking Union), of measures, which aim at breaking the link between levels of sovereign indebtedness and bank bail outs. A very important lesson is how the EU has recently apportioned the costs of the Cyprus rescue to private stakeholders, such as shareholders, bondholders and large depositors, treating essentially the latter as investors.²⁰²

EU Member States have set up, in the course of the last 60 years, institutions in order to manage the challenges of a multi-faceted integration process and provide acceptable structures for political and democratic accountability. EU institutions have also been used by the Union in order to accumulate knowledge and expertise that may be useful in responding to new challenges. But we should be careful in arguing that the EU institution-building experience, or for that matter the EU integration process, given the specific characteristic of internal market,²⁰³ can be used as the only reform template, although they can indeed provide model lessons to the rest of the world.²⁰⁴

The impact of institutions dealing with financial markets has mostly been ignored, probably because economists regarded such impact as ‘unimportant’²⁰⁵ in a free market environment. So while the EU is obliged to take drastic steps to cover gigantic gaps in its policy and regulatory framework to prevent irrevocable fractures in financial integration, it still needs to proceed with caution, as all this is untested territory. This caveat puts the usefulness of lessons drawn on EU institution-building experience in the right context.²⁰⁶ Moreover, it should be noted that the ECB had never had a ‘treaty-based’ mandate to act as shock-absorber in the Euro area sovereign debt markets. Absence of this mandate will continue to represent a missing link in the

²⁰² For a complete analysis of the Cyprus bailout plan and of its implications see Financial Times, In depth, ‘Cyprus bailout’, available at <http://www.ft.com/in-depth/cyprus-bailout>

²⁰³ For example, the EU has a rather well developed banking sector that eventually became a threat to the fiscal position of certain member states. The size of Eurozone’s banking system as a share of overall economy stood at over 300 percent in the pre-crisis period, whereas by a comparison, the banking system forms only 100 percent of the overall economy for the US. This implies that the largest euro area banks are a much larger part of any individual national economy within the EU zone.

²⁰⁴ Wouters, J., & Ramopoulos, T. (2012).

²⁰⁵ Allen, F. (2001). Do Financial Institutions Matter? *Journal of Finance*, 56, 1165-1175.

²⁰⁶ Allen, F., & Carletti, E. (2011). New Theories to Underpin Financial Reform. *Journal of Financial Stability*. doi: 10.1016/j.jfs.2011.07.001

EU reform process. Finally, the European Banking Union may not be seen as an entirely irreversible development. Taxpayers and governments from both the core and the periphery of the Eurozone may, in the end, decide that the wider and abstract good of further European integration and of the stability of the single market is not worth the loss of sovereignty, and perennial austerity and sacrifice of national interest that they seem to entail. Accordingly, East Asian economies, must find which parts of the European project are successful and suitable to them to adopt and which parts are either of dubious success or would lead to an intolerable loss of sovereignty in a region that is not accustomed to any considerable degree of political integration.

Where, however, the EU experience is invaluable is in supplying policy-makers with irrefutable evidence about the axiom that, although financial markets may be established anywhere, provided that certain property rights are recognized by local law, in the absence of restrictions on cross-border flows, their stability may only be guaranteed through appropriate institutions and not by reliance on market forces' rationality and co-ordination. Therefore, arrangements to safeguard the stability of the cross-border market cannot be delayed until formal integration efforts reach a peak in Asia, whether in the form of establishment of a single currency area, or otherwise. Waiting until then might prove fatal to the Asian financial integration process. Therefore, in the East Asian context building the necessary infrastructure for the operation of integrated financial markets is very important.²⁰⁷

In the case of East Asia the complexities involved in harmonizing common practices, standards, and specifically the legal rules for such diverse economies mean that European Banking Union type institutions are not feasible in the foreseeable future. Yet this does not mean that the leadership of those countries should not think about the challenges to financial stability created by increasing market integration and financial interconnectedness in the region. It only means that for the time being, other less strongly integrative measures, such as subsidiarisation, are probably more suitable and effective in the East Asian context than the EU's plans for centralization of cross-border bank supervision and resolution. In addition, while establishment of a single regulator with power to intervene and discipline banks in ASEAN+3 is probably not feasible at present, building a macro-supervisory umbrella is essential for the undisturbed

²⁰⁷ ASEAN+3's 'Group of Experts' initiative in securities clearing is a first step in this respect. See also above, s. IV.C.1.

continuation of East Asian integration. In such a case, the function of macro-prudential oversight ought to be discharged by an independent body in order to secure credibility and authority, even if it is a soft law body.

Arguably, in an increasingly globalised world, formal international cooperation in the field of financial stability and cross-border bank supervision and resolution, might in the long run come to be seen as a necessary ingredient of national prosperity in an environment where national financial markets are closely integrated.²⁰⁸ This would become especially the case if ongoing national and regional reforms prove to be less successful than expected.²⁰⁹ Building multilevel financial governance in a region as economically and politically integrated as the EU is infinitely less complicated than a similar attempt at the global scale. The same might apply to replication of EU plans in another region. Of course, these may, in the end prove more challenges to be overcome rather than insurmountable stumbling blocs. Either way Asian policy-makers should not assume that they have ample time to deliberate before another major crisis breaks out. They should urgently start with the business of augmenting the region's financial stability mechanisms in order to safeguard the future economic prosperity of the region and the lesson drawn on the Eurozone crisis may prove very useful in this process.

²⁰⁸ For an example of such a model for the governance of global financial markets see Avgouleas, E (2012).

²⁰⁹ E.g., James Barth contends that not everyone is convinced of the new regulations in place (in case of the US, the Dodd-Frank Act) has solved the too-big-to-fail problem, yet, the biggest banks have not been downsized despite the presence of a general consensus from various stake-holders. He quotes from Sheila Bair (Former FDIC Chair, Fortune, February 06, 2012), Richard Fischer & Harvey Rosenblum (FRB of Dallas, Wall Street Journal, April 4, 2012), and, Simon Johnson (Professor at MIT, Bloomberg, October 10, 2011). See, Barth, J. R., & Prabha, A. P. (December 03, 2012). *Breaking (Banks) Up is Hard to Do: New Perspectives on Too Big to fail*. Financial Institutions Centre. Retrieved from <http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf>

